PROCEEDINGS

OF THE NINTH ANNUAL

Institute on Accounting

Held at

THE OHIO STATE UNIVERSITY

MAY 16 AND 17, 1947

Sponsored by

THE DEPARTMENT OF ACCOUNTING
COLLEGE OF COMMERCE AND ADMINISTRATION
THE OHIO STATE UNIVERSITY

Edited by

THE BUREAU OF BUSINESS RESEARCH
THE COLLEGE OF COMMERCE AND ADMINISTRATION

FOREWORD

The Ninth Annual Institute on Accounting was held at The Ohio State University on May 16 and 17, 1947. This was the occasion for the celebration of the Twenty-Fifth Anniversary of the establishment of the Department of Accounting. The College of Commerce and Journalism (now known as the College of Commerce and Administration) was organized in 1916. Courses in accounting had been offered in the Department of Economics and Sociology for a number of years under the leadership of Professory Clifford C. Huntington. In 1922, Professor George W. Eckelberry was named the first chairman of the new department. The growth of the department, both in size and in course offerings, has kept pace with the rapid development, recognition, and important contribution to the national economy which has characterized this young and virile profession during the past quarter of a century. Professor Eckelberry was succeeded in turn by Professors Howard C. Greer, J. Brooks Heckert, Jacob B. Taylor, Russell S. Willcox, and Hermann C. Miller. Student registrations in accounting courses have grown from a mere handful to the present high registration of nearly 3,200 in a single academic quarter. Increasing interest in graduate work in accounting leading to advanced degrees has become an accepted fact, and programs for such study have been developed.

As an added service to the profession, the Annual Institute on Accounting was introduced in the year 1938. From the first, these programs have drawn both large and quality audiences. The attendance at the Ninth Institute was excellent evidence of the sustained enthusiasm and interest of the many public, industrial, and governmental accountants, corporate officials, and educators who have returned year after year to these conferences on accounting. A total of 409 registrations were made this year. In addition to these, many students of accounting at The Ohio State University availed themselves of the opportunity to attend the sessions.

Special mention is made here of the deep gratitude of the administration officials of the University, College, and of the members of the teaching staff of the Department of Accounting for the splendid cooperation and important contributions made by the guest speakers and the session chairmen who came to the campus for this Ninth Annual Institute of Accounting.

As in all previous meetings, the student members of Omicron Chapter of Beta Alpha Psi and of Lambda Alpha Sigma contributed in an important manner through their personal services in the physical arrangements, registration, and ushering services.

Looking forward to the Tenth Annual Institute on Accounting, this opportunity is taken to announce the dates—May 21 and 22, 1948. All interested persons who may not have enjoyed the previous meetings on The Ohio State University campus are cordially invited to attend. Others who have attended in the past will be warmly welcome to return and enjoy the renewal of friendships, to meet new leaders in the field of accounting, commerce, and industry, and to listen to a timely program. Announcements will be mailed and programs will be distributed in advance of the meeting. However, it is frequently possible that mailings may go astray, or changes in address may have occurred. A postal-card request, giving the correct mailing address, will be assurance that advance mailings will reach their proper destinations. Such requests will be most welcome to those responsible for this phase of our preparations. Address your request to the Bureau of Business Research, College of Commerce and Administration, The Ohio State University, Columbus 10, Ohio.

HERMANN C. MILLER
Chairman, Department of Accounting

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ANNUAL ACCOUNTING INSTITUTES AT OHIO STATE UNIVERSITY

SPEAKERS

1938

PROFESSOR HIRAM T. SCOVILL, President of Illinois Society of C.P.A.'s
PROFESSOR ROY B. KESTER, Chairman, Committee on Education, American Institute of Accountants
STUART C. MCLEOD, Secretary, National Association of Cost Accountants
THOMAS TARLEAU, Legal Assistant to Under Secretary of the Treasury
VICTOR H. STEMPF, Chairman, Committee on Federal Income Tax, American Institute of Accountants
C. HOWARD KNAPP, Vice President, National Association of Cost Accountants
CLEM W. COLLINS, President, American Institute of Accountants
GEORGE C. MATHEWS, Member, Securities and Exchange Commission
ERIC CAMMAN, Partner, Peat, Marwick, Mitchell & Company
HOWARD C. GREER, Institute of American Meat Packers
PROFESSOR ERNEST A. HEILMAN, President, American Accounting Association

1939

ALBERT W. TORBET, Partner, Frazer and Torbet
SIDNEY G. WINTER, President, American Accounting Association
PROFESSOR FELIX E. HELD, Ohio State University
LIONEL P. KRISTELLER, Chairman of Insurance Section of American Bar Association
F. P. BYERLY, Chairman of Committee on Cooperation with the American Bar Association of the American Institute of Accountants; Member, Price, Waterhouse & Company
JOHN W. BRICKER, Governor of Ohio
GEORGE D. BAILEY, Partner, Ernst & Ernst
WILLIAM F. MARSH, Partner, Lybrand, Ross Bros. & Montgomery

1940

PROFESSOR WILLIAM A. PATON, University of Michigan
C. HOWARD KNAPP, President, National Association of Cost Accountants
HOWARD C. GREER, Vice President and General Manager, Kingan & Company
VICTOR H. STEMPF, President, New York State Society of C.P.A.'s and Vice President, National Association of Cost Accountants
MAURICE E. PELOUBET, Member, Executive Committee of American Institute of Accountants
JOHN HASKELL, Vice President, The New York Stock Exchange

1941

HENRY T. CHAMBERLAIN, President, American Accounting Association
WILLIAM W. WERNTZ, Chief Accountant, Securities and Exchange Commission
ERIC A. CAMMAN, Past President, National Association of Cost Accountants
J. A. PHILLIPS, Committee on Federal Taxation, American Institute of Accountants
DAVID FRIDAY, Economic Consultant, Washington, D. C.
CHARLES REITELL, Stevenson, Jordan & Harrison, Inc.
HENRY M. KIMPEL, Director of Finance, City of Cleveland Heights

1942

PROFESSOR H. GORDON HAYES, Ohio State University
ERIC L. KOHLER, Editor, *Accounting Review*
HERBERT F. TAGGART, President, American Accounting Association
MASON SMITH, Partner, McKinsey, Kearney & Company
PROFESSOR C. O. RUGGLES, Graduate School of Business, Harvard University
HARRY E. HOWELL, President, National Association of Cost Accountants
DONALD M. RUSSELL, Partner, Lybrand, Ross Bros. & Montgomery

1943

Max M. Monroe, Comptroller, Inland Manufacturing Company
James L. Dohr, Director of Research, American Institute of Accountants
Randolph Eide, President, The Ohio Bell Telephone Company
Carman G. Blough, Chief, Contract Review Branch, Procurement Policy Division, War Production Board
George S. Olive, President, American Institute of Accountants
Jacob B. Taylor, Army Service Forces

1944

William A. Paton, University of Michigan
Hiram T. Scovill, University of Illinois
Victor H. Stempf, President, American Institute of Accountants
Logan Monroe, Controller, The Eaton Manufacturing Company
Howard C. Greer, Vice President and General Manager, Kingan & Company
Frank Carlson, Member, House Ways and Means Committee, House of Representatives, U. S. Congress
Walter A. Cooper, Peat, Marwick, Mitchell & Co.

1946

Curtis B. Atkisson, President, The Institute of Internal Auditors, Inc.
D. M. Sheehan, Vice President, Controllers Institute of America
Thomas Tarleau, Member of the Committee on Postwar Tax Policy
Mark E. Richardson, Member of the Committee on Taxation, American Institute of Accountants
Louis Bromfield, Author, Lucas, Ohio
T. Dwight Williams, President, The American Institute of Accountants
Frank Klein, President, The National Association of Cost Accountants
Eric L. Kohler, President, The American Accounting Association

1947

T. Coleman Andrews, Director of the Corporation Audits Division, General Accounting Office
Arthur E. Hald, President, The Institute of Internal Auditors
J. K. Lasser, Editor of The Tax Clinic in *The Journal of Accountancy*
Eric Camman, Past President, The National Association of Cost Accountants
Edward B. Wilcox, President, The American Institute of Accountants
John H. MacDonald, President, The Controllers Institute of America
John W. Paynter, Assistant Controller, J. L. Hudson Company
John R. Wood, Jr., Prentice-Hall, Inc.
Harry R. Edwards, Controller, F. & R. Lazarus & Company
Myron S. Kem, The Dayton Rubber Manufacturing Company
Harrison W. Wilder, Partner, Ernst & Ernst, Detroit, Michigan

FIRST SESSION

FRIDAY, MAY 16, 1947—10:00 A. M.

Commerce Auditorium

Chairman:

JOHN C. MARTIN, C.P.A., *President, The Ohio Society of Certified Public Accountants*

Address: "Accounting and the Management of Public Affairs"

T. COLEMAN ANDREWS, C.P.A., *Director of the Corporation Audits Division, General Accounting Office, Washington, D. C.*

Address: "The Internal Auditor Looks at Company Policies"

ARTHUR E. HALD, *President, The Institute of Internal Auditors, Inc.; Auditor, Consolidated Edison Company of New York, Inc., New York, New York*

INTRODUCTORY REMARKS

By John C. Martin, C.P.A.

President, The Ohio Society of Certified Public Accountants, Columbus

It is my privilege and pleasure as president of the Ohio Society of C.P.A.'s to welcome you to the Ninth Annual meeting of the Institute on Accounting, sponsored by the Department of Accounting of Ohio State University.

Some of you will remember that prior to 1937 the Ohio Society of C.P.A.'s was accustomed to holding a spring meeting, usually here at O.S.U., in addition to the annual fall meeting which was rotated between the various chapter cities. Since 1937, with the exception of the year 1945, the Department of Accounting has prepared for our pleasure and instruction on current accounting and related problems these fine spring programs and has honored the Ohio Society of C.P.A.'s by permitting their president to preside at the initial session.

These spring meetings have become much more important, both to the members of the Ohio Society of C.P.A.'s and to the other friends of the members of the Accounting Department here at O.S.U., in that they enable us to hold a reunion with many others whom we have known in past years but who have not entered the public accounting field.

There are many different organizations represented at these meetings: the American Institute of Accountants, the National Association of Cost Accountants, the Internal Auditors Institute, Inc., the Controllers Institute of America, the American Accounting Association, and others.

This meeting has a special significance since it commemorates the 25th anniversary of the establishment of the Department of Accounting at the Ohio State University. During these 25 years the department has been expanded and improved until it is now recognized by the public accounting profession as one of the foremost leaders in the United States in training students for public and private accounting practice. This achievement has been gained under the very capable leadership of professors George W. Eckelberry, Howard C. Greer, J. Brooks Heckert, Jacob B. Taylor, Russell S. Willcox, and Hermann C. Miller. Before this the instruction in accounting was conducted under the leadership of Professor C. C. Huntington.

Among the groups which use this occasion as a time of reunion are the two professional accounting fraternities, Beta Alpha Psi (the men's group) and Lambda Alpha Sigma (the women's group). Both of these fraternities will hold their initiation meetings on Saturday night and they will cordially welcome all active and alumni members.

Now to proceed with the specific problems to be discussed by our speakers. After having attended the Council meeting of the American Institute of Accountants at Asheville, North Carolina, the first three days of this week and a lengthy session of the Board of Directors of the Ohio Society of C.P.A.'s yesterday, in addition to many meetings in connection with a proposed bill in the Ohio Legislature for the regulation of public accounting, some of us may feel that accounting legislation is the most urgent current accounting problem. We do believe that not only Ohio, but all of the states have entered an era in which the legislative problem will be a continuing problem, even if not the most important one. This is evidenced by the fact that 27 states have had bills concerning the practice of public accounting introduced in their legislatures. In addition, there is before the United States Congress S. B. 503, Senate Joint Resolution 42, and U. S. Budget Document for 1948.

The general theme of this Institute on Accounting is "The Accounting Aspects of Business-Policy Determination." Mr. T. Coleman Andrews will now speak on "Accounting and the Management of Public Affairs."

ACCOUNTING AND THE MANAGEMENT OF PUBLIC AFFAIRS

By T. Coleman Andrews, C.P.A.

Director of the Corporation Audits Division, General Accounting Office, Washington, D. C.

In an excellent article entitled "The Accounting and Treasury Functions In a Modern Organization," Mr. J. A. Campbell, a prominent accountant of Chicago, made the very sage statement that "the accounting department pays its way by serving the business, not by trying to run it." I doubt that anyone could frame in fewer words a more accurate and inclusive statement of the fundamental purpose of accounting than was thus expressed by Mr. Campbell. It will be my purpose in this paper to indicate at least one important way in which accounting can be made to serve business. But before I start let's be sure we all understand what I mean by the word *"business."*

Most of us, I fear, think of the word *"business"* as connotating only the activities of private enterprise. Even those of us who think of it as encompassing a wider field often use it in the restricted sense. It is by no means a word of narrow application. Business activity is involved at some point in almost every aspect of human life. Government, for instance—one of the most important aspects of living—is business, the biggest business in the world. The late Franklin D. Roosevelt called it not only the biggest, but also the most important business in the world. If government is business—and I agree that it is—there can be no doubt about its relative immensity; and, business or not, the pre-eminence of its importance can not be denied.

For the benefit of those who require the authority of the lexicon, I cite Funk and Wagnall's Modern Dictionary. It defines the word *business* as embracing, among other things, *commercial affairs*, *a matter or affair*, and *interest*, *concern*, *duty*. The creation, management and servicing—to use a word common to public administration—of an aggregate federal, state and local debt of 272 billion dollars, and the assessing, collecting and spending of 50 billion dollars in one year, certainly involves engagement in *commercial affairs*. This also seems to dispose of the second definition, namely, *a matter or affair*. And surely no one will challenge the definition: *interest, concern, duty,* for surely nothing is of more interest to all of us, nothing is of greater concern, especially these days, and nothing imposes a higher duty upon any of us, than government. And so, let's understand that government as well as private enterprise is business, for it is primarily about the use of accounting in our governmental business that I propose to talk from here on out.

On the whole, the administration of public affairs does not require the use of involved accounting systems, procedures, or techniques; except in occasional special situations, the requirements are simple. But many years ago somebody got the idea that the budgeting of income and expenditures called for special methods and techniques, and somehow or other enough public officials fell for the idea to give it a firm foothold; and enough accountants swallowed it to make C.P.A. problems in "municipal accounting" the reef on which the hopes of many a promising aspirant to an accounting career were wrecked. The whole business of governmental accounting became a confusion of fancy terms: estimated receipts, receipts, revenues, appropriations, authorizations, allotments, allocations, encumbrances, obligations, expenditures, unrealized estimates of receipts, unallocated appropriations, unobligated allocations, unencumbered allocations, unexpended balances, and so on. Thus governmental accounting became an end unto itself and utterly useless as a managerial device. As a result, accounting became to the average public administrator just a "necessary evil."

In a paper entitled "Accounting Problems of a Government Agency," read by Eric L. Kohler, C.P.A. of Chicago, at a Conference on Federal Accounting, sponsored by the American Institute of Accountants and held in New York City on December 2 and 3, 1943, the author made this statement: "From a comparison of governmental operations with those of private business, it is difficult to imagine why Government accounting requirements should offer difficulty. Only simple expenditure accounts seem to be necessary, provided, of course, agreement can be reached on the definition of 'expenditure.' In practice, involved systems of accounting are the rule rather than the exception; not put to active administrative use, they are frequently badly designed and in arrears. Causes are numerous, the principal one being that accounting needs have been met with concepts that have tended to make accounting an end in itself, rather than a means of information and control useful alike to agency management, supervisory financial agencies, and the Congress."

Mr. Kohler spoke from intimate knowledge of the deficiencies of governmental accounting. He had already put in many years trying to bring order out of some horrible examples of what governmental accounting isn't. He has seen his efforts rewarded in the Tennessee Valley Authority, where he proved the validity of his criticisms by demonstrating that accounting could be made simple in a governmental agency and still be made to satisfy every budgetary requirement. He also had made it popular with, and indispensible to, the management of the Authority. His method was simple. He merely used the principles and techniques of plain everyday accounting. For instance, in the classification and distribution of expenditures, he applied the principles of cost accounting; he provided for the recording of expenditures in such a way that the end result was to show the cost of every activity of the Authority. He made the ascertainment-of-activity costs the primary aim of the system. Objective classification of expenditures was given secondary, if not incidental, importance. Contrast this with the usual practice of putting primary emphasis upon objective classification and the usefulness of the activity approach is at once apparent.

The activities of the Tennessee Valley Authority are somewhat unusual, however; hence, they are not typical of governmental departments and agencies generally. So I will not undertake to explain the Authority's system in detail. Instead, let's apply the principle used there to a familiar setup and see how it would work.

First of all, let us remember what a business organization does and what it is in such an organization that costs money. A business organization establishes and carries on such activities as are necessary to the accomplishment of the purpose or purposes for which it was created. The *activities* that it carries on *are what cost money*.

Then let us remember what an organization's accounting system is supposed to do. It is supposed to be useful to management. If it is to be useful to management, it must present the facts of the business in a manner consistent with management's way of looking at the business. And how does management look at the business? It looks at it as a group of activities which, properly co-ordinated and managed, will accomplish the over-all objective of the business. It looks upon expenses as what they are and nothing more: as the cost of goods and services acquired for the carrying on of the activities of the business. Whether one kind of goods or services, or some other kind, is used by an activity isn't important of itself. What is important is whether the kind used was needed, whether it was the most appropriate kind to the need, and whether its cost was right. The fact that two or more activities use the same kind of goods or services and that the total cost was so much, is of little value to management.

To illustrate, in a business with two or more departments and several activities, a reliable judgment of whether the total cost of telephone services is in line cannot be formed until it is determined that each department's portion is in line; and no judgment as to any department's portion can be formed until it is determined that each activity's portion is in line. Hence, if expense accounting is to be useful to management, its primary objective must be the accumulation and disclosure of activity costs, and the kinds of things and services a business buys are of importance mainly at the activity level, where the need for them, their appropriateness, and their cost can be adjudged and the benefits derived from the use of them can be appraised.

Now let's go a step further and see how this would work in practice. For the purpose of this demonstration, let's use some ground that will be a bit more familiar to most of us than a department of government. Let's use the accounting department of a private enterprise. The usual activities of such a department are: auditing of income and receipts, auditing of expenses and disbursements, inventory accounting and control, pay roll accounting and control, the keeping of vendors' accounts, the keeping of customers' accounts, the keeping of the general books, internal auditing, and so on.

In most businesses the practice as to the classification of expenses is not even to ascertain the expenses of the accounting department as such, let alone the cost of the several activities that constitute the department. The controller's salary probably will be included with those of other executives in both the books of account and the financial statements. The salaries of the employees of the department, generally, probably will be included in a catch-all item, like "Salaries of Office Employees," along with the salaries of clerks, stenographers, and other white-collar employees of other departments. The cost of telephone service probably will be shown as one item for all departments, so also the cost of stationery and other so-called "office expenses." No one in the world would be able to look at the books of account or financial reports and see what the word *office* includes, that is, what departments it includes and what the activities of these departments are. Even the total cost of the accounting department is not indicated, let alone the cost of each of the activities that constitute it. I call this sort of accounting *obfuscation*. Certainly it is not useful information.

Only by classifying the expenses of an organization, whether it be a private enterprise or a division or other unit of government, so that the structure and activities of the organization and the cost thereof will be revealed, can anyone hope to have an understandable basis for judging the necessity for, or reasonableness of, the organization's expenses. By such classification it is possible to compare the cost of the fundamental elements of the organization from month to month, quarter to quarter, and year to year, or any other desirable period. Such classification and comparison also will reveal at a glance any changes that are made in the structure and activities of the organization, as well as the trend of the costs of the continuing departments and activities. Thus, the existence of a new department or activity and its cost are immediately disclosed, as is also the discontinuance of a department or activity.

Now I am fully aware of the fact that a large percentage of business organizations—and let's not forget that we are still talking about governmental, as well as private, business—are too small to warrant a clean-cut separation of every activity, that very often a single person may be found taking part in, or even having sole responsibility for, one or more activities. In such cases one must apply the rules of common sense and practicality. I'm not talking about splitting hairs.

To illustrate the application of activity classification and reporting to public affairs, I'll lift from my memory and experience an actual, though disguised, organization. We'll see how it was set up, how its expenditures were being reported, and how they are being reported on the activity basis.

The various jobs that this organization is charged with doing are divided between twelve bureaus. There are twelve operating "divisions," therefore, to use a common term for operating units of an organization. The office of the head of the organization is divided into three sections, one of which takes care of the organization's general administration, or housekeeping; the other two provide advisory services to the head of the organization. Thus the organization consists of sixteen main sub-organizations: the head man's office, the administrative unit, two service units, and twelve operating units; and each of these sub-organizations engages in at least three activities in the process of carrying out its main function.

All that the public ever saw of the cost of this organization—and it spent a lot of the taxpayers' money—was an over-all statement of its expenditures objectively classified, that is, showing how much was spent for salaries, how much for telephone service, how much for stationery, how much for traveling expenses, and so on. This appeared in the annual budget of the unit of government of which the organization was a part. There was nothing to show the cost of the sub-organizations, let alone the costs of activities.

It was sometimes amusing to see what happened when an inquisitive legislator got hold of the organization's budget requests and started asking questions. Invariably there would be a demand for a breakdown of expenditures by organizational units and activities. It took a lot of digging and no little fancy juggling to answer these questions without disclosing a lot of things the organization didn't want to disclose. The significant thing about this illustration at this point was the point of view of the management—the legislators, members of the board of directors. They wanted to know the costs of activities, but the books hadn't been kept that way. *They weren't responsive to the requirements of management.*

Well, what happened was the usual thing. The legislators finally got tired of being given the run around, and a change was ordered. Today the organization's books and financial reports show the cost of the head man's office, the cost of each section thereof, the cost of each operating division, and the cost of each activity of each of these sixteen units of the organization; and this showing is carried over into the organization's budget requests. Hence, when anyone looks at the organization's financial reports or budget, he can see clearly what the structure of the organization is, what activities each organizational unit is engaged in, and what the cost of each activity is. Thus, if he is struck by the character or amount of any object of expenditure, he can appraise it in relation to the activity on which it was spent.

Incidentally, this piece of accounting surgery paid a handsome dividend. It led to a tremendous increase in the quality of the work done by this organization and an over-all reduction of 25 per cent in the costs of doing it. It also led to the official demise of a gentleman who evidently regarded the holding of a position of high public trust as a warrant to make suckers of the people who have to pay the bill. It disclosed the fact that the head man enjoyed the luxury of an expensive chauffeur-driven automobile that served no purpose other than the satisfaction of his vanity and an exaggerated feeling of importance. Soon after this discovery the name on his door was changed. He was able to cover up this extravagance when there was no breakdown of expenses, but not so after activity accounting was adopted. Did someone say that accounting doesn't pay off? Or was it that accounting is just a "necessary evil"?

Finally, I think I should point out that the placing of emphasis upon the cost of activities runs counter to the hopes of those who seek uniformity of accounting and reporting, particularly the latter, and especially in government, by placing emphasis upon objects of expenditure. However, I do not think this need give anyone concern, because the kind of uniformity that is obtained by putting emphasis upon objects of expenditure was nothing but another commission of the old mistake, so often made, of making accounting an end in itself. The whole idea was doomed to failure from the start because it was a turning of the back upon the fundamental role of accounting for a purely self-serving bit of mechanics.

It is utterly fallacious to believe that anyone but the managers, and possibly the owners, of a small business could get any value out of statements of expenditures that show only the total cost of each kind of goods or services purchased, without regard to how the business covered by the statements is organized and in what activities it engages in order to accomplish its purposes. Such understanding certainly cannot be expected of legislators, who have little time from their legislative duties to gain first-hand acquaintance with such immense and complicated departments, bureaus, institutions, and other agencies of government as exist today. And, if we cannot expect such understanding of our elected representatives, what about us, the poor taxpayers?

The best citizen is one who is interested in his government. The most interested are those who know what is being done with their money. The only way to impart such knowledge is to publish the facts in a manner that clearly discloses the organization of the government—whether it be federal, state or local—the activities in which it is engaged, and their costs.

Let's remember that the products of the ingenuity and efforts of the accountant are not devised for the benefit of the profession; they are devised for the benefit of the owners and managers of business, whether it be public or private, and for the man on the street. If we fail to meet their requirements, we fail in our professional mission.

There is no such thing as uniformity in business organization and management or in human understanding. Instead there is *multiformity*. The requirements of multiformity are what we must meet if we are to have any hope of justifying ourselves.

CHAIRMAN MARTIN: Thank you, Mr. Andrews.

Mr. Arthur E. Hald will now speak on the subject, "The Internal Auditor Looks at Company Policies."

THE INTERNAL AUDITOR LOOKS AT COMPANY POLICIES

By Arthur E. Hald

President, The Institute of Internal Auditors, Inc.; Auditor, Consolidated Edison Company of New York, Inc., New York, New York

Introduction

Any discussion of policy must proceed from a determination of what policy is. Simply expressed, policy is a way of doing things. Generally, the various dictionaries define policy as a course or method adopted and followed by a government, institution, body, or individual. To determine what policy is in all its respects, procedures and methods must be included.

Any review of a company's organization and operations must be founded on what the mission of that company is and what are its policies. The policies give vitality to the mission. They are the administrative means by which the purposes of the company are accomplished. Policies cannot be inert, they must be alive and they must be flexible enough to reflect changing conditions. The mission or goal of the company may not change but the means of accomplishment can and, in most cases, should. Static policy often indicates a decadent organization.

The Basis of Policy

Policy is usually thought of as some formal, written pronouncement by a management authority. To a considerable degree this is true. Such written policy is usually found in rules, orders, and procedures for the guidance of executive, administrative, and line personnel. The determination of such policy is a matter of examining the record.

There is, however, a large part of policy which is not written and which is just as significant a part of operations as written policy, and in some cases, even more so. This unwritten policy is found in the traditions and habits of industry, and in the attitudes and thinking of men. It reflects itself through the entire organization in the methods of operations and in the cost of doing business. Fundamentally, it is more important than written policy because it is accepted as a normal way of doing things. It is an avenue by which waste and inefficiency can enter any organization. Unquestioned acceptance of these traditions and habits is a sure way to stop progress and to surrender markets to more progressive competitors.

External Influences in Creating Policy

A large part of company policy is not freely created. Statutes, regulations of governmental authorities, and union influences form a large part of the foundation of policy. These external authorities and influences affect practically every phase of doing business. There are statutes, both federal and local, which determine or influence policy in finance, personnel, sales, safety, sanitation, and welfare, to mention some. In the regulated industries, such as the public utilities and railroads, they govern accounting methods, reserves, rates, and the character of service. These regulations extend to the terms of contracts that can be awarded for construction and to the length of time that records and underlying data must be retained in storage. Some of the regulatory bodies created by law have semijudicial authority to inquire into, investigate, and render decisions which vitally affect the administration and organization of privately-owned business. The decisions of these bodies affect and create policy.

Integration of Policy Created at Various Levels

Where the making of policy can be freely exercised without external influence, all levels of authority within an organization can, and usually do, create policy. When policy is imposed or influenced by external authorities, the various levels of supervision have less freedom and are limited principally to the interpretation and administration of policy.

The making and execution of policy can permeate the entire organization when there is a freedom to exercise discretion. Within degrees, each level of supervision can create policy. The executive level usually determines policy on a more or less broad basis. Interpretation of that policy and its administration, mainly through the medium of executive orders and methods, must necessarily be left to other levels of authority in the organization, from the department head to the first line of supervision.

In the fields of industrial and commercial relations, intermediate and lower levels of supervision, to a very significant degree, influence policy, and, to some extent, create policy. These fields both deal with human relations. In many organizations, by necessity, there is an unavoidable insulation between the executive levels and the operating employees and the average run of customers. By their closer and more intimate contacts, the lower levels of supervision have a better concept of the attitudes and habits of mind of both employees and customers and are in a better position to detect those sore spots which can have detrimental effects.

Many companies allow considerable latitude to the intermediate and lower levels of administration in the making and execution of policy as it affects people. It is a wide practice to have frequent meetings of supervisors and local managers to discuss the problems of relations with employees and customers. Through these forums there is a free interchange of experience and ideas which are influential in determining policies and their interpretation and administration. Policy making is not a percolating process from the top to the bottom. The reverse is often true. The firsthand experiences of those who come in contact with people are valuable in making executive decisions.

In connection with branch or district operations it is often advisable for local management, within reasonable limitations, to make policy as it affects its area. Not all communities have the same characteristics. Racial origin, economic circumstance, and local customs and traditions are significant factors in dealing with people. Policy should be made and adjusted to meet these factors. When standards are inflexible, they may create relationships which are harmful.

Effects of Policy

Policy can have both tangible and intangible effects. The tangible effects can be evidenced in costs and operations. The intangible effects can be evidenced in the attitudes of people. In both cases, there is an economic effect. The tangible effects of policy can be expressed in better or poorer operations, lower or higher sales, costs—up or down—and better safety experience. The intangible effects of policy can be expressed in the content or discontent of employees, in the satisfaction of customers. It is difficult to evaluate these effects of policy. They are probably more important to determine than those effects which are visible as a matter of record. They can produce industrial harmony or disorder, and successful or unsuccessful disposal of products. They can affect costs and production as a result of employee attitudes, and income as a result of customers' attitudes.

Accounting Implications of Policy

Policy has effects on accounting in methods or in results or in both. These effects are reflected in:

1. The accounting and clerical routines necessary to record the factors arising out of the policy.
2. Accounting controls.
3. Income or other accounting position.

Some policies have extensive effects on clerical routines. When the policy is imposed by external authority, factors of economy and control become secondary. There is no choice by management. The job has got to be done in the best way possible. The requirements of these policies must be fitted into the accounting system or the system must be amended or changed to meet the necessities of statutes, regulations, and union contracts. Descriptive of this effect on accounting and clerical routines is the changing of clauses in union contracts. The almost yearly adjustment of these contract clauses, many of them novel in nature and difficult to fit into the pattern of pay-roll systems, causes problems in the keeping of personnel records, pay-roll methods, and cost accounting. Policy determined by government, through statutes, regulations, and decisions, also complicate methods and routines. Income tax and social security withholdings from employees' wages, and the adding of taxes based on sales to customers, have added costs and created problems of control and accounting. Usually these clerical and accounting methods, with their attendant costs to fit policies determined by outside authorities, are economically disadvantageous to a company. When union influence or the different divisions of government create or influence policy, business has got to follow.

When the creation of policy is within the free determination of the company organization, an evaluation can be made of the cost and control factors of the clerical and accounting procedures. If the policies create undue costs or have an effect on the adequacy of control, policy adjustments can be made accordingly. Before a policy which will cause changes in the accounting and clerical routines is undertaken, a cost estimate is usually made and, if burdensome, the policy can be changed to produce the best economic result. Such is not the case when policies are determined under statutes, union influence, or government regulations.

When policies relate to physical functions, such as operation, property construction, and sales programs, they produce an accounting effect. A change in policy may cause a change in accounting results. Costs of operations can rise or fall and revenues can fluctuate under policy-and-method changes.

All changes in accounting results arising from policy may not be physical in foundation. Policy decisions may be entirely accounting in nature with no effect on the way of doing business. New methods for the distribution of overheads may affect costs. Assets may be revalued or reclassified. New reserves may be established or the basis of appropriations to existing reserves may be changed with the results reflected in the income position. Policies of accrual or prepayment accounting may be changed to cause variations when compared with previous periods.

In appraising accounting results, it is necessary, when comparing periods, to determine the variations which have an underlying physical cause and those which are caused by changes in accounting policy, particularly as they affect the net-income position.

The Functions of the Internal Auditor

How do all of these factors of policy fit into the job of the internal auditor? The designation and the purpose of internal auditing poses problems of explanation. The term *internal auditing* is neither descriptive nor informative. It is an arbitrary term because no better one, correctly describing the function of "internal auditing," has been devised.

The title *auditor* has been used in corporate organizations for many years. The duties assigned under this title were many and varied. They embraced the entire area from the executive head of the accounting department to individuals performing routine checks and verifications of such items as receipts and disbursements. No matter what the function the "auditor" performed, his job was part of the accounting mechanism of the company.

There is a changing concept of the job of the auditor. His functions are being broadened by the necessities of modern-day business. He is now required to look not only into, but beyond the confines of the accounting system and to objectively examine and evaluate the entire corporate organization. As progressively practiced, internal auditing is a management-staff function. In some companies it remains as part of the accounting organization, in others it is an independent group unaffiliated with any other department and reporting to management on the executive-staff level. This evolution of internal auditing has been a natural result of the complexities of the operation of today's business. Operations in many of our corporations are on a voluminous and far-flung basis. Single departments have grown to a size and complexity of duties comparable with fair-sized corporations of some years ago. Mergers and consolidations have been significant factors in corporate growth. Such bigness is difficult to centrally manage.

Executives cannot hope to personally supervise as they have in the past. They must rely for unbiased, firsthand information on organized substitutes to inform them of the conduct of operations in the departments and districts of the company organization. Internal auditing has been developed to assist management in making the surveys which it can no longer do in person.

Internal auditing is one of the youngest of the professions. It is now developing a philosophy, a purpose, and a goal. It is a means for making certain to management that policies are being observed and administered in accordance with their intent, and that operations are being carried on efficiently and effectively.

Internal auditing has been defined as, "The organized activity on the part of management to assure itself of proper adherence to company procedure and policies, and to secure the benefits of a systematic and objective verification and constructive analysis and appraisal of the accounting, financial, and other aspects of a company's operations." (Brink, *Managerial Control Through Internal Auditing.*)

Possibly, as the years pass, the function of internal auditing will be given another name more descriptive of the duties. The controller had his beginning as the head bookkeeper. His job is now a major one, with officer status, in the affairs of corporations. The growing complications of doing business may, in time, offer a parallel in the status of the internal auditor.

Some companies do not leave the creation and interpretation and administration of policy to go unchecked. The checking of policy factors is, to a considerable degree, a part of the functions of the internal auditor. Operating in a field of broad perspective, in which the operations of all parts of the company are included, he is in a favorable position to note aspects of policy or method which might be significant in savings or better methods.

The internal auditor can be an effective liaison agent. Experience has shown that the various divisions or branches of an organization, even where the duties are common in character, are incompletely informed as to the operation of the other divisions. The internal auditor can be valuable in acquainting these separate units of the details of policy and methods of each other to the advantage of each.

The interpretation and administration of policy, in large organizations, must necessarily be left to the various levels of authority within the company. This is applicable whether the policy is freely created within the organization or determined by external authorities. It sometimes happens that somewhere, within the organization, there is a failure to know of the existence of a policy because the pipeline of information has become clogged or diverted. It more frequently happens that the requirements of a policy are not understood. In other cases both knowledge and understanding of the policies are present, but the administrative technique is not effective. The internal auditor in these cases can be valuable. He can furnish the knowledge and proper interpretation of policies and be helpful in the correction of the defects in the avenues of information. Where the administration of policy is poor, he can be constructive in his comments to cure it.

Internal-Auditing Methods Affecting Policy

It is not a simple matter to develop auditing reviews of policy on a program basis. Policy offers too many complications. The internal auditor, if he is competent and effective in his job and has that innate sense, which characterizes a good auditor, will develop an attitude of mind towards policy. By his habits of thinking and the experience he gains in making his reviews, he can evaluate policy and methods and their administration as effective or ineffective, and efficient or wasteful. No matter by what routine steps he performs his tasks, there is a fundamental with which he must be acquainted, and that is what the policies are that apply to the subject of his review. He should acquaint himself with all the details of policy, both determined internally within the company and originating from external authority. This knowledge does not come rapidly and is usually acquired over a period of time as a result of repeated surveys.

There are a few generalizations which are helpful and useful in formulating methods of review. When the policy originates from external authority, such as statutes, regulations, or union contracts, the following should be considered:

1. That the requirements of the externally determined policy have been made effective in the company organization.
2. That the procedures and methods used in the various departments and divisions of the organization meet the requirements of the policy.
3. That the various levels of administration and authority in the company have a good understanding of the meaning of the policy, and their interpretation and actions are consistent with its intent.

In those cases where policy has its origin in the traditions or habits of the company or industry, or there are factors of community or other local characteristics, it is advisable to determine the following:

1. The origin or underlying reasons for the policy.
2. A comparison of results with other divisions or locations in which similar conditions are treated differently.
3. The consistency of the policies with the objectives and purposes of the company and the attitudes and pronouncements of its top management.

Under policies freely determined or created internally in the organization, consideration should be given:

1. That the policies are consistent with national, state, or local statutes and ordinances and regulations and with union contract clauses and collective bargaining procedures and decisions.
2. That there is a consistency in interpretation and administration in the several executive and supervisory levels.
3. That there is a cohesion of policies created by the various administrative levels or in the various divisions and locations which make for consistency even though there might not be complete uniformity.

All studies of policies and methods made by the internal auditor should have the economic effects as an objective. This is true even in those cases where the policy is determined by outside authorities. Management should be informed of the results of policy whether they be good or bad. When the results of freely determined policies are poor, the policies can be changed to get better results. When externally determined policy produces poor results, management can adopt whatever means it has at its disposal to influence a change in the policy.

Although a significant part of the internal auditor's duties are concerned with the review and evaluation of policy, there are substantial reasons why he should be cautious in intruding on the making of policy as it affects other agencies of the company which are subject to his examination. He should confine his policy-making authority to his own activities. His findings can be a guide and an influence in the making of policy, but they should avoid the creation of policy. Each department or division in a company has its duties and its responsibilities. Included in those duties are the development and supervision of policies and methods. The responsibility for efficient accomplishments should be wholly that of the department or division. If the internal auditor, in the course of his surveys, developed new policies or methods for the use of other departments, he would be responsible for the ultimate results, particularly if they were bad. He would jeopardize his independence to be critical of a method or a policy which he had created.

Conclusion

The subject of policy is complex because it has many characteristics and many effects. Policy has its origin in traditions, and customs, in the authority of government, and in the attitudes and thoughts of people. Business has had added to it, by the rules of government and by union influence, obligations primarily social in concept. Companies now operate under a mixture of policies—those which are freely determined within the company organizations and those which are imposed by statutes, regulations, and union authority. All of these policies have a result on costs and ways of doing business.

Because of the ever-mounting burden or responsibilities and the expanding nature of business in recent years, executives have been to a considerable extent precluded from making personal observation of the details of administration and operations which normally had been their practice. Reliance for unbiased factual reporting of conditions has had to be placed on staff agents, among them being the internal auditor. As progressively practiced in many organizations, the functions of the internal auditor include the examination and appraisal of all activities of the company. Internal auditing is developing a new professional status. It is creating standards and philosophies which include the review of policy and its results for the information and guidance of management.

SECOND SESSION

FRIDAY, MAY 16, 1947—1:00 P. M.

LUNCHEON

Baker Hall

THIRD SESSION

FRIDAY, MAY 16, 1947—2:30 P. M.

Commerce Auditorium

Chairman:

JOHN L. CAREY, *Secretary, The American Institute of Accountants, New York, New York*

Address: "Minimizing Tax Outgo Through Business Policies"

J. K. LASSER, C.P.A., *J. K. Lasser and Company; Editor of* THE TAX CLINIC *in* THE JOURNAL OF ACCOUNTANCY, *New York, New York.*

Address: "How Accounting Can Help in Running a Business"

ERIC A. CAMMAN, C.P.A.; *Past President, The National Association of Cost Accountants; Partner, Peat, Marwick, Mitchell and Company, New York, New York*

INTRODUCTORY REMARKS

By John L. Carey
Secretary, The American Institute of Accountants, New York, New York

I have had the pleasure of attending most of the nine Institutes on Accounting conducted by The Ohio State University, and I think that they have been remarkable for a number of reasons. Unlike most accounting meetings, these Ohio Institutes do not try to cover in two days the whole water front and to deal with every topic of interest to all kinds of accountants. Instead they have all had central themes which have tended to explore fairly thoroughly one aspect of the very great variety of uses and influences of accounting in our economic life.

The second distinctive characteristic of these institutes has been that they have brought to bear all available views and opinions on the subject under discussion; in other words, the work hasn't been carried on exclusively by certified public accountants or cost accountants or teachers of accounting, but by all of them.

I think the advantages of both of these characteristics are obvious. In the past ten or fifteen years there have been events or trends in our social development which have focused attention on one or another of these various uses or influences of accounting—in income taxation, in the expansion of credit structure, in reporting to absentee owners of corporations, in cost control, in the procurement of war material, and in the recapture of war profits. Various aspects of these uses and influences have been explored at earlier Ohio Institutes.

With their usual clear perception of what is timely, those responsible for this Institute have arranged a discussion of the uses and influences of accounting in an area which has acquired new and vastly increased significance in the past year or two. Business policy is recognized today as a matter with very broad public interest. Price policies, wage policies, employee-benefit policies, dividend policies, and financing policies are in the news as they never have been before. Accounting has, or should have, a large part in policy determination in each of these fields. I think the theme for this Ninth Ohio Institute is most fortunate.

This afternoon there are to be two speakers. They are both outstanding C. P. A.'s. Each is nationally recognized in his own field as an authority to whom appeals are frequently made, but from whom none is ever taken. They will speak on two of the most important aspects of policy determination related to accounting. The first subject is "Minimizing Tax Outgo Through Business Policy." Everyone here knows this speaker by reputation and all of you have read his writings. The list of his honors and his accomplishments is very long. He is now chairman of the New York State Society's Committee on Federal Taxation and is a member of the American Institute's Committee on Taxation. He is the author of several books, *Your Income Tax,* which has sold somewhat over 8,000,000 copies; *The Business Tax Guide; The Business Executive's Guide;* and so forth. He is the editor of the *Handbook of Accounting Methods* and of two handbooks on tax- and cost-accounting methods which will be published in the near future. He is the editor of "The Tax Clinic" in *The Journal of Accountancy.*

In addition to being a virtuoso, this man is a benefactor of the accounting profession. He has given perfectly incredible amounts of time and knowledge to educational activities, to the dissemination of tax knowledge through the New York University Institute on Taxation, of which he is the initiator and the organizer, and through similar projects in Penn State College and the University of Miami in Florida. I have never known him to refuse a request to help a professional organization no matter how much work it involved for him personally. His appearance on this platform this afternoon is wholly in character. I give you Mr. J. K. Lasser.

MINIMIZING TAX OUTGO THROUGH BUSINESS POLICIES

By J. K. Lasser, C.P.A.,

J. K. Lasser and Company; Editor of THE TAX CLINIC *in* The Journal of Accounting, *New York, New York*

I am to spend an hour with you explaining why and how business management ought to be interested in the work of tax planning. By tax planning for business, we mean the serious study of our mechanics of achieving objectives like these for business:

1. Insuring less income or greater deductions.
2. Getting more exemptions.
3. Avoiding the double taxes that so often hit corporations or their stockholders.
4. Getting a lower tax rate.
5. Stepping up a cost basis.
6. Achieving a better position for a family.

This is an effort to review some of the studies we encounter in our hunt for these six rainbows. This, then, is the tale of the taxman's daily pursuit.

Why Tax Planning?

Before I get too far, let's first agree that those of us in practice subscribe to much of that recent *Fortune* statement:

> To say that (tax) avoidance is immoral is sanctimonious nonesense.[1] . . . Avoidance, unlike evasion, is not a crime but a right, the exercise of which is sometimes abused. But the taxpayer who through neglect or ignorance fails to

[1] The rest of the *Fortune* paragraph from which this was abstracted is worth footnoting: "There are certain kinds of avoidance which the government intends that all taxpayers should practice. It expects a man to invest in tax-exempt bonds. It does not expect him to lie about the amount of compensation he receives during the year. Somewhere in between these two extremes there exist a type of avoidance that goes beyond the intent of the law. The taxpayer is morally and legally justified in utilizing any avoidance device that, in his opinion, does not go beyond this point. He is free to interpret the intent of the law as liberally as he wishes; the Bureau of Internal Revenue will tell him if he has gone too far. If, by properly ordering his economic activities, the taxpayer (individual or corporate) can reduce his tax liability, he has accomplished a valid business purpose. He has minimized a cost that affects his profit position as much as, or more than, any production cost. He may sell depreciated machinery instead of trading it in on replacement machinery if by so doing he will reduce his tax liability; he may make a charitable contribution in stock that has appreciated in value rather than in cash, and thereby reduce the tax cost of his gift. The objective of all such tax planning is to minimize the part of the taxpayer's property or profits that he must turn over to the tax collector, and it is one of the most important considerations in making money today."

minimize tax liability to the full extent permissible by law is in effect paying more than his fair share of the price of "civilized society."

Let's also agree at the outset that tax planning is often essential for business survival. It is imperative for us to take all the permissable advantage in the law, administrative rulings, regulations and interpretations. Through that businessmen often can, to a large extent, overcome inherent economic disadvantages and even managerial deficiences. On the other hand, failure to use available tax knowledge may completely overcome other economic advantages and excellent engineering management. Thus the test of survival is not entirely efficiency in production or operation; it has become heavily weighted by tax considerations.

I'd like to argue that tax-consciousness minimizes and reduces the risks of business. The reverse is also true: a disregard of the implications of taxation produces business loss. It also means a great social loss. It is to the public interest to keep the most efficient producers in business. It is not entirely true that a business with greater efficiency, greater productivity, less waste, has the greatest net return after taxes. These are often pushed aside by a less efficient competitor whose tax planning sometimes makes up for the productive advantage of the more efficient.

Perhaps I can change the whole complexion of our approach to tax reduction by talking of tax alternatives. You are free to choose them just as you are free to choose the automobile business in preference to the oil industry. No bureaus or courts as yet intervene. If you are good at your selection, you may make some money.

And that is all there is to tax planning. You pick one way instead of another. Both may carry the blessing of good accounting, the tax law and the courts. One may give you a lot of what seems like an unreasonable return on your investment.

Let me see if I can prove that point by discussing some of our elections in one small part of the field of taxation.

Buying a Business

You may be about to buy a business or a business asset. Certainly you will want to plan your transaction to avoid paying a tax on the return of your purchase price.

Assume you agree to buy corporate stock for $1,000 when the corporation assets had cost $100, but are now worth $1,000. This price of the stock reflects the higher market values (over costs to the selling corporation) of, say, its real estate, etc. But when this real estate is sold, both the corporation and you (when dividends are distributed) will pay a tax on a book profit.

That is a very foolish step. You have no real profit. You are merely getting a return on your capital invested. You must, therefore, make your deal so that your buying plan does not include that penalty. You have got to seek a purchase of assets, or to get an adjustment for the penalty you are assuming.

Assume another company you want to buy will cost $100. This company has assets costing $50—$40 of surplus and $10 of capital. The assets are now worth $100. If immediately (after you buy its stock) your new company pays dividends, you will have ordinary dividend income up to $40. You really should get no income until you have recovered your $100. You ought to avoid that penalty. To do that you must find the way to buy the assets at a $100-cost.

These are two normal cases that require buyers' alternatives. And yet buyers usually forget them.

The whole business of alternatives in buying anything seems today to divide itself up into four principal points. We always have them before us when we are discussing a problem with a buyer. They run this way:

1. A buyer should remember about the special relief sections in the law—the carry-overs, tax-benefit rules, and the great number of averaging methods that exist *only for the seller*. The buyer must not lose them.

2. A buyer ought to buy so that he gets the greatest possible tax deduction for himself—when it should be secured.

3. A buyer ought to try to make sure that when he sells what he buys, he will get capital gain on the disposal of his assets—where it should be secured, and I shall talk about that later on.

4. When he buys, a buyer should avoid paying a tax on the purchase price or on the accumulated earnings that exist in the seller's company. I have given you two examples where that usually occurs.

Let's develop one of these points, the first—making sure that a buyer gets all the advantages usually given a seller. Many factors want to be watched in careful planning:

1. A successor may have to pay a tax that would not have been paid by the old company on items like the following:

Gains that might have been offset by prior years' net operating losses, unused credits, unused capital loss carry-overs.

Gains that might be offset by liabilities incurred by the predecessor that were contingent or indefinite at the time of conversion. Only the predecessor may have the deduction for expenses accrued during its operation.

Receipt of income taxed to the successor that would not be taxed to a predecessor, for example, tax refunds and recoveries of bad debts, etc., where the predecessor took the deduction but got no tax benefit. Also, income might be created when it otherwise might not exist, viz., life insurance proceeds might be taxes in cases where the predecessor would be exempt—you are taxed when you acquire the property for a valuable consideration (which is true except in case of tax-free organizations).

Denial of a deduction for the successor that might be given to the predecessor. For example: deductions for unamortized bond discount on bonds continuing to remain outstanding—these are not available to successors—many types of debtor's taxes and interest are deductible only by the company liable for the tax—they are not deductible by the successor.

2. Sometimes the incident of the conversion creates a tax that might have been deferred. Income may be created that might not otherwise arise until a later date. For example: a company using the installment-sales basis may have income at the moment of the liquidation, rather than in later periods. There are many other similar situations for immediate taxation of the income that might be deferred.

What can you do to avoid the loss when you purchase a company? Here are a few principles, but many other need study:

1. Keep the old company alive and retain enough assets to pay its debts, when it has operated on a cash basis or when on an accrual basis and it has contingent or contested liabilities. Then it may use the deductions.

2. Retain installment obligations in a company taken over and keep the old company alive. It may then report them over a period of years and pay taxes due on the prorated profit.

3. Do not transfer life insurance policies. See if it is wise to hold a company alive to collect proceeds that might be otherwise taxed.

4. Generally, study the carryback system to find if you should keep your old company alive. That will allow you to take full advantage of all credits and allowances.

Of course, our buyer should seek a deduction for his interest or dividends. He wants to buy greater deductions, more exemptions, greater basis for many assets. For the latter, he may willingly take a lower basis on other assets. This point suggests that if he can adjust the price of the *parts* that go to make up a *bulked* purchase price (say a purchase of the assets of an entire business), he will get the higher figure placed on the following assets:

1. Merchandise inventory, stock in trade—a high cost will reduce profit since your cost would be fully deductible.

2. Supplies and similar items not used in the manufacture of the product—these supplies will be used as expense items in the ordinary course of the business. Your cost is fully deductible.

3. Accounts receivable—loss from bad debts would be business bad debts and fully deductible.

4. Machinery, equipment of short life—the short span of depreciation gives you little time to recover the cost. Loss on sale or abandonment is fully deductible.

5. Patents, copyrights, franchises, etc., amortizable intangibles—you recover cost rapidly by getting reduction of income over the short period left for amortization. But value property at low figure if you propose to sell the asset. Then you may have a capital gain.

6. Covenant of the seller not to compete with you—the payment is fully deductible over the period of the covenant.

7. Life insurance policies—payment of proceeds at death is ordinary income to buyer when it might not be taxed to seller. But a resale would be given capital asset treatment. If you plan to resell, evaluate this low so you can get the 25 per cent maximum tax. Only exception to gain on buyer is when buyer is the insured or when buyer is a transferee in a reorganization.

In any allocation of a bulk price, our buyer would want to get the lower figure placed on these assets:

1. Stocks, bonds and securities—gain would be taxed at capital gain rates.
2. Buildings, building improvements; machinery, equipment of long life—long period of depreciation to recover cost. Loss on sale or abandonment fully deductible.
3. Land—no depreciation period to recover cost. Gain would be taxed at capital gain rates.
4. Good will—only recovery of cost would come from eventual sale of business. But place some value on good will in order to have a cost basis. Any profits in a sale would be capital gains.

Of course, this only scratches the surface of our buyer's alternatives. That is all I can do as I run along in this tally of the hunt for the six rainbows I discussed when I started this.

Seller's Alternatives

One of the elections in the laws is whether a seller shall pay a 25 per cent tax on his sale of assets—or whether he will pay up to 85½ per cent in taxes on his gains. Much of the time he has the choice. Too often he slips into the heavy tax because of bad timing, bad advice, or indifference.

And in business we constantly face the desire to get a 25 per cent tax to the seller and an ordinary deduction to the buyer. Sometimes it is possible. For example, payment of sums not to compete over a period of years are always to be taken up as ordinary income by employees, officers or stockholders of a selling corporation. That may *not* be true if a corporation sells its business. On the other hand, on a sale of a business by a corporation, the purchaser may agree to pay an officer of the vendor-corporation sums in consideration for his noncompeting. Then the officer would receive these payments as ordinary income. If the capital-gain type of transaction can be arranged, the vendor gets capital gain ,and the purchaser gets full deduction.

Many other ways might give the seller a capital gain and the buyer an ordinary deduction on a sale of property. Here are sàme examples:

In one case four people (not professional inventors) transferred patents to a company. The transfer was under an agreement by which the company was to pay them 80 per cent of the gross income from licenses upon the patents. This secured a capital gain of some $40,000 to the vendors. The court held this sum to be deductible royalty by the buyer. The theory was: the patents were amortizable purchases; the business was entitled to recover its cost of the patents over their life; the actual cost (the aggregate of the 80 per cent payments) was not determinable and could not be secured until payments ceased; a reasonable allowance for depreciation of the patents would therefore be the actual annual cost paid for them.

In an earlier case a stockholder assigned his patents to a company for 5 per cent of net profits for the entire life of the patents. The practical difficulty of measuring annual amortization with an agreement in which there was no payment except when there were profits, warranted a deduction in each year of the 5 per cent of the profits.

Seller's determination of the price is also very important. If we can do it, we should sell the following assets at a high price, giving ground on the price of other assets:

1. Accounts receivable and supplies not in inventory and not entering the product—a gain is called a capital gain by some authorities.

2. Machinery and equipment, land and buildings used in business held for more than six months—profit is a capital gain if held over six months and losses are ordinary deduction. Adjust your basis of price to best arrangement for yourself. If the asset was held for less than six months, seek a return of your cost.

3. Patents, copyrights, and other amortizable assets—you have a capital gain on profits and an ordinary deduction on losses.

4. Good will, undeveloped land not used, land and buildings not used in business and business interest in other ventures—you have a capital gain on a profit if the asset was held over six months. But if you have a loss you have a capital loss—not deductible except from other capital losses. That may mean you should seek a return of your cost if you do not get a gain.

Avoiding seller's double tax is one of our major studies. That comes when your corporation sells its assets and then liquidates the proceeds to stockholders. If a corporation sells first, it pays one tax on the profit. The later liquidation of the surplus produces another tax for the stockholder. We think we avoid the double tax if our record shows *one* of the following:

1. A minority stockholder carries on negotiations before any dissolution. He agrees to transfer the assets he secured *only* if he can induce the liquidation. He acts entirely in his own interest as a minority stockholder and has no authority to bind the corporation.

2. Negotiations are begun after the liquidating distribution. They are carried on by trustees elected by, and representing only, stockholders (not the directors or the corporaion and not as trustees in liquidation). They are not participated in by the corporation in any way. It had no important connection with any prior negotiations.

3. Assets are offered widely to the broadest possible group and to the highest bidder (after dissolution) by a public, rather than private offering.

4. The purchaser always understands he is negotiating only with the stockholders for the purchase of his assets, if they can secure them in liquidation.

Sometimes the corporation should welcome the double tax. The use of a corporate sale may permit a double deduction. If there are assets in a corporation that are to be sold at a loss, a double deduction will be obtained if the corporation sells at a loss and then liquidates. The stockholders in turn will realize a loss. In these cases, the carryback provisions may even get a good return of prior years' taxes.

This scratches only the surface of seller's alternatives. Other points for your check list include:

1. Selling so that a part of present annual earnings are capital gains. For example, you may sell a business for a fixed price plus a percentage of the profits for a fixed term of years; then the latter might be a long-term capital gain taxed at 25 per cent. That may be much more advantageous than paying a tax on the ordinary business income at full rates.

2. Selling on the installment basis—you may sell a long-term asset at a profit and have payment made in installments over a period of years. And if you are using the installment basis, sellers want to avoid taking interest on the installment payments. Instead you will gain, tax-wise, if your sales price is increased. Interest is fully taxed, while long-term capital gains are only taxed at a maximum of 25 per cent.

3. Deferring the tax on income from the sale of property to a year later than that of the sale. Your ability to control the year in which you are taxed on a sale may have some bearing on the way you make your transaction. Generally, you are taxed in the year when title passes. But you need not pay a tax if you cannot determine the market value of the purchase payments with fair certainty. The courts hold these not to be a basis for determining gain or loss until your consideration is actually collected. Sales of property may also be encouraged at times by proving that receipts are not income because proceeds are restricted in the year of the sale. That may come when:

a. Securities, or other property received, are nontransferable for a specific term—say, five years. The restricted property has been held to give no present income.

b. Property taken has no value now, but has the possibility of developing into greater value later. You pay no tax now.

c. Property taken is merely a contract to receive payments *when*, *as*, and *if*, profits or sales arise; it may have no fair market value now. You pay a tax on those receipts when you get them, or when the profits or sales are determined. In these cases you may postpone the tax because you cannot judge with fair degree of accuracy how much (if any) will actually be received.

d. Right to your income is indeterminate. You await determination of what you are to get before you have income. Thus if vendee's payments are escrowed to be delivered to you only on clearance of substantial encumbrances, you await release of the funds before you owe a tax. The same would be true of escrow payments to cover vendor's warranties. The rule also applies to escrowed monies held pending clearance of litigation or government approval to the transaction. They are not actual payments until released. (However, if title is presently delivered, but the property sold is held in escrow until certain conditions are met, then the income may be taxed now.)

e. Buyer's note or bond has no fair market value because payment is conditional (upon approving of title, etc.); or the payment is contingent or uncertain. You owe no tax when these obligations are received.

And these, too, touch only part of our problem for the seller.

Reorganizing a Business

Tax planning may involve changing the form of a business. We may do that because of more favorable rates or exemptions given one form—and not another. But there are many other reasons that govern our decisions. For example, here are some that controlled recent switches from a partnership to a corporation:

1. In one case we got a division of a partnership into a great many companies that gave us: lower rates (since the corporation tax is easier on smaller incomes); an exemption from surtax on one company—since it did business in South America; varying fiscal years for different members of the group, so as to conform wih their natural years—*much lower taxes all around.*

2. In another we got a new fiscal year without consent of the Treasury. Also we selected the new year at a time when we got much less than 12 months partnership income into the partner's last year. That deferred a lot of tax to another year.

3. In another we got a short corporate year. That also deferred a lot of tax to later years.

4. In another we wanted a step up in value to present market values. Our partners could afford a capital gain. This gave us a new large basis for the same assets in the hands of the new corporation.

5. In a great many we have simply sought a method of dividing income without Treasury criticism. Making members of a family stockholders is entirely approved. Creating partners out of your relatives is not in rhythm.

6. In another we simply wanted to postpone payment of tax for a year. The individual must pay-as-he-goes. The corporation pays in the next year.

7. In another we wanted to get partners into a profit-sharing and pension plan. We had to have them as corporate officers to permit that.

These are but a few examples. There are many more. We are constantly studying the tax planning that warrants changing from

1. Partnerships to corporations and the reverse
2. Dividing corporations into many parts or assembling them in one unit
3. Liquidating some, merging others, abandoning still others

This is only a small fraction of the studies to find the right form for a business. Other methods of tax planning are often even far more lucrative. Let me list a couple of ideas:

1. Often our best organization contemplates leasing our assets instead of direct ownership. We may do that if we can get a rental payable only

a. Out of sales increases, or

b. Out of profits, if we can induce the owner of the facilities to play ball with us.

2. Many times we go into joint ventures with other businesses. That avoids the corporate tax to the joint venture. We get the direct division of income and losses as they occur. Individuals in business can get an enormous amount of tax control through joint ventures. Here are two examples:

a. A and B formed a syndicate to buy stock. Profits and losses were to be shared equally. These losses are deductible when they occur even if one of the parties takes 10 years to pay the other for his share.

b. A and B want to do the same thing, *but A wants to be sure to control the year of his loss, if one is sustained.* B purchases the securities. A tells B that he will share gains and losses equally. A then gets a loss when he pays B his share. In this case the loss to B occurred in 1929. In 1930 A gave B his note for his share of the loss. He paid the note in 1941. That, held the court, was the year of his loss. (A was not deemed *a joint adventurer.* He was merely under an obligation to reimburse B for losses.)

3. The much condemned cooperative might be used a lot in business for these reasons:

a. Profits earned in a joint venture may be split on the basis of sales, without a tax first being paid by the cooperative.

b. Rebates upon purchases from the central source dealing for the group are readily arranged.

c. The cooperative avoids many difficulties encountered when there is a parent-subsidiary or related company arrangement. They run the danger that

(1) Deductions will not be permitted to the parent companies for contributions to the central agency.

(2) Income of the subsidiary or common agent may be taxed to it. This is so even if it is fully paid out to the stockholding companies.

Many times our studies concern the *way* we shall reorganize. Let's discuss just one example in that class of studies. Most of the time we seek tax freedom when we incorporate a partnership, but sometimes partners should pay a tax to incorporate. A partnership may have low-basis assets, with high values now. The tax-free exchange will give the new corporation the same low basis. When the assets are sold by the corporation, the corporation will be taxed. Its stockholders will be taxed again when the profits are distributed as dividends. It may be wise for the partnership to sell low-basis assets for cash and then turn over the cash to the corporation, or they may turn over assets to the corporation in a taxable transfer. They will if they want the corporation to get a higher basis for the assets of their partnership. They might do it by paying a capital-gains tax of 25 per cent on the sale of their partnership interests to the corporation. When we find that condition, we know four ways to get a stepped-up basis:

1. The securities are distributed to the partners in proportions which are *not* similar to their partnership interests.

2. Some of the securities may be sold for cash to outsiders. Then (in exchange for the partnership assets) some of this cash is paid to one partner. The securities are paid to the other partners.

3. The partners pay cash for the corporation's securities. The corporaion then buys the partnership assets for cash at market value.

4. The partners receive other property or cash in addition to securities; otherwise, the exchange complies fully with the rules for making the exchange tax-free.

Suppose your partnership has assets now worth much less than cost. Shall they be transferred to the corporation? The answers vary for particular cases. If we can use the loss to cancel out partnership income, we try to sell assets and take the loss before the transfer. If you expect the corporation to earn substantial amounts, you might deliver the low-basis assets to the corporation; then, have the corporation take the loss.

The mechanics of changing to a corporation may be highly important. Seven notes can be made:

1. If you incorporate a partnership reporting on the accrual basis, keep the partnership alive. If you have contingent or contested liabilities (such as damage claims for accidents), leave the partnership sufficient assets to pay the claims. If the new corporation pays these contingent or contested liabilities, they may have to be capitalized; then neither the old partnership nor the new corporation has the benefit of a tax deduction. The partners *will* ordinarily get the benefit of the deductions if the partnership pays these liabilities.

2. If you incorporate a cash-basis business, pay off all liabilities first, or have the noncorporate business retain enough assets to pay them off. Thus you get the benefit of the deductions. If these liabilities are paid later by the corporation, they must be capitalized.

3. Be cautious about tax-free transfers when the capital-investment ratio and profit-sharing ratio in the partnership are different. Example: A and B contribute $10,000 each to the partnership, but A gets 75 per cent of the profits and B gets 25 per cent of the profits. In this case, to be tax-free, we would have to distribute stock equally to each. Hence, each would be sharing equally in the profits. One case suggests that you must transfer stock to the partners based only on their *capital* proportions; otherwise, you may have a taxed transfer. Forget the ratios in profits if they are different.

4. A nontax-free transaction calls for *value* of assets contributed, rather than cost. You might use appraisers in some instances.

5. Suppose there are limited partners who receive a fixed amount annually as share of profits. You may continue this after incorporating. Give preferred stock in appropriate ratios to your former limited partners upon incorporation. This would still leave the transaction tax-free.

6. Some believe that there is considerable peril in the *liquidation* of a partnership and the formation of a corporation. The problem arises where

a. Some assets are worth more, or less, than book figures.

b. Some assets (like good will) are not recorded on the books.

Our difficulty is due to this fact :upon the liquidation of a partnership and the distribution of property in kind to a partner, the basis of his property is the same as the basis of his partnership interest.

7. If you organize a corporation out of your partnership, remember the Section 102 penalty. Do not transfer too much cash or investments to the corporation.

Paying Salaries

One of the most fertile fields for tax planning is in compensation. Our system of free enterprise depends for its entire existence upon men—their perspiration, their ingenuity, and their leadership. Free enterprise will work only if we can give free men the desire and the incentive to expend their talents. Instead, our tax laws are a real brake on our most important individuals. That is because our system takes so much after salaries reach up over $10,000 or $15,000. After $20,000, your added payments go at least 50 per cent to the government. At $50,000, the tax collector takes almost 70 per cent of additional sums, and at $90,000, you are giving up 75 per cent of the next dollars you earn. What, please, are the chances to encourage men to more perspiration, intelligence, and leadership? Common sense says these rates should never exceed 50 per cent of any earnings.

If taxes continue at their present high levels, they may in effect cause a managerial revolution. They are today, in endless examples, removing the incentive to work for a considerable number of our most enterprising and skillful management talent.

Tax planners have an enormous obligation to help curb this managerial revolution. That means a constant search for approved plans to:

1. Defer compensation to later years when the tax might not be so high.
2. Possibly eliminate the tax altogether by avoiding direct payment.
3. Defer the tax to a period when the employee might possibly get a capital gain for his services.

We avoid the taxing of compensation entirely by a great many plans that are a part of good management. For example:

1. Paying for group health and life insurance.
2. Paying for education, hospital, community facilities.
3. Paying the sums direct to labor unions for disbursements entirely under their control, for example, payments patterned on the Coal Fund. If the union has complete discretion on the disbursement, the employees are not taxed.
4. Paying widows or beneficiaries directly. Often that may be entirely without tax to the widow.

We defer tax on income to other more hopeful years by such steps as:

1. Plans for pensions and profit-sharing.
2. Contracts to pay that restrict disbursement until contingencies stipulated are cleared.
3. Contracts paying small amounts now—higher later.

We may get the employee a capital gain instead of ordinary income by doing this:

1. Selling him stock at the market price—permitting him to sell it in the open market when his efforts produce a higher value.

2. Selling him special stock at a nominal value. For example, you may elect to sell stock that has little present value but a large potential value. Employees would have no tax to pay when the potential was realized if they actually bought this stock at its fair market value when it was issued, nor would they have tax if they did not fully pay for the stock until it reached its higher value. They would owe a capital-gains tax only on the sale of the stock.

Accounting Rules

Tax accounting basically follows good accounting. That is why it is easy for accountants to handle such matters. That statement is true except for two theories. One is the special rule that accords relief for particular circumstances. It often gives us averaging systems, carry-overs, tax-benefit devices, cancellation mechanics, and a good many other aids.

There is another set of rules that we call barnacles. They arise from bad accounting decisions in the courts. They are distortions. If you know them, you can make great gain out of them. If you do not know them, you may lose a great deal.

Suppose a restaurant opens near a factory and sells a number of 50-meal block tickets in December. When he makes up his year's return, the owner will be surprised to learn, often too late, that all the receipts for the 50-meal tickets are income in that year—even though most of the meals will have to be furnished during the next year.

Or suppose a health club is started and memberships that are good for a year or two are sold. The rules insist that the income be reported for taxes long before the services are rendered and the outlays made.

Or take the case of a new roofing contracting business which makes repairs giving a ten-year guarantee. Everyone knows that out of the sales in any one year must be provided a reserve for future repairs to cover liability under the guarantees. Yet the rules insist that *all* the sales income must be currently reported—regardless of the fact that a lot of money received must be used to meet the guarantees in future years.

Or take, if you will, the man who has rent paid in advance. He makes a five-year lease and is paid one year in advance. He may be surprised to know that the year's payment in advance is income. It is income even though in a succeeding year he must supply the tenant with services which may cost him money. It is income even though he has just paid a broker 10 per cent to get the lease, and even though the broker's fee is going to be spread over the five-year period and not deductible in the year in which he is required to put that advance payment into his tax return.

Stupid, you say? Unreasonable? Sure. But these are all part of our tax-accounting scheme—the part I labeled as barnacles. And you want to know them or else you are going to suffer a great deal of loss. At the same time we say that you suffer a great deal of loss, we automatically say that if you know them, you get tax economies through observance of the rules. Now, tax accounting requires the knowledge of these decisions. If you know them, you may gain. The easiest case to prove that is to refer to my landlord; if he knows the barnacle he will not take the advance rent as rent, but will take it as a security, or in trust, or in some other way.

Most other examples of horrible tax-accounting principles can be used in tax reduction if you know the alternatives. In a vast quantity of conditions, the alternatives will permit you to select the year in which you want your income and to defer your costs to the period in which you would like to have them deducted. For example, it is easy for us to move sales from one year to another by the alternatives in the law. We may select, if we choose, consignments, approvals or deposits that do not clash with the decisions. It is also easy for us to select the character of cost in this year which will give us a deduction this year. And we can defer costs to some other period when we want the deduction in some other year. It may also be easy for us in this year to take all sorts of hedges that will permit the costs to come in this period even though the advantages may come in some other year.

Blueprint for Minimizing Tax Outgo

I've scratched the surface of tax planning. I've told you just a bit about our alternatives—these elections that save money for the initiated. These are all part of a daily business existence for professionals. If you really are in business for keeps, and if it is not all in a spirit of wholesome fun, then technicians will want to talk this stuff.

How can you use these alternatives to best aid your clients? One way is for you to recognize that the most important tax studies upon which the technician can aid today are somewhere in the following list. This simply is a list of tax audits ahead of all of us in our 1947 contacts with business:

1. The right form for business activity and how to convert to that form. Should business operate ventures or cooperatives? Or operate personal holding companies or partnerships? Or a dozen other forms? And how do you make the change from what you have over to the better form?

2. The right way to buy and sell business property so as to get the greatest

gain. How, for example, do we get the greatest deduction to the buyer and a capital gain taxed at 25 per cent to the seller?

3. The way to operate real estate or leased premises in the light of the host of special rules. How, for example, can the landlord get large rentals at no tax when the tenant makes improvements in his property? How do you get the greatest deduction for the landlord and the tenant in the large income years? What is the best way to sell real estate? How do you take advantage of deferred rent, advanced rent, foreclosures, and all these other things? The alternatives in the tax law permit great gain if you know them.

4. The method of financing a business that gives you the greatest gain—tax-wise. For example, how can you get an interest deduction and yet give your security holder a capital gain when you really pay his interest—quite like the method the government uses in its E bond dealings. How can you pay interest this year for obligations maturing in later years by cleaning up obligations now? How can you recapitalize now so as to get greater interest deductions, recognizing our difficulties with decisions? How can you acquire obligations in financing or refinancing so as to get the smallest tax? How can you avoid difficulties with redemptions and cancellations, and get capital gain when you do redeem in this financing?

5. The artificial tax-accounting rules—how to use them to your best advantage. For example, you can avoid paying a tax on: many debts cancelled by creditors or stockholders; many adjustments with your vendors; recoveries of items deducted in loss years; many forms of income under foreign exchange; many forms of dividends; many items under involuntary conversions or exchanges, etc. How to handle prepaid income? How do you handle prepaid taxes that are contingent upon the payment of bills? How do you avoid tax on restricted and disputed and uncertain and contingent items? For example, if a salesman is to get his money only when your customer pays his bill, you have no deduction for that salesman in the year of the accrual—the year you have to make the customer's billing. Under the rule, if a contract says to that salesman, "I will pay you only when you are paid by my customer," you get your deduction only when the customer pays. But the law does not prevent you from changing the salesman's compensation method if you want your deduction.

6. The alternatives for doing business abroad. For example, your new company doing business almost exclusively in Canada or Mexico can avoid the corporate surtax. There are a lot of other alternatives in the statute. You want to study sections permitting us to set up an organization abroad, when you consider that company you are setting up. When you do, also study whether you avoid the Section 102 tax for the new company. And can you liquidate the new company without tax? Do you pay tax only on the foreign business?

7. The opportunities, like dividends in kind, for avoiding for the corporation any tax cost on distributions to stockholders.

8. The ways of getting the greatest deduction for compensation to employees with the smallest possible cost to them. This might come from options, stock sales, deferred payments, pension and profit-sharing trusts, and a hundred other alternatives.

9. The methods of using the net operating loss and the many other aver-

aging methods, like the tax-benefit rule, the capital loss carry-over, etc., to the greatest advantage. That may mean: planning of business income, expenses, acquisitions, new ventures, sales *this* year, as against another year; quick settlement of costs now; inventory clearances; etc. Too few people realize that losses as far as 1948 might give us back excess-profit taxes paid in 1944. That has a tremendous effect on what elections we make in 1947 and 1948.

10. The ways of building personal estates out of a business that might not be taxed out of existence by double taxation or by inflation. I've talked a bit about the former. The latter usually suggests giving away any increment that might be due to inflation at no gift cost today.

I trust that I have at least conveyed to you that there is a large job before the strange breed of tax students—the breed who continue the hunt for the *way to minimize the tax outgo of business*.

CHAIRMAN CAREY: Mr. Lasser has done the brilliant kind of job that everyone expects as a matter of course.

Cost accounting, as everyone here knows, has become one of the principal branches of the accounting art. One of its most ardent, most effective, and most distinguished exponents is the man who is going to speak to you next. He is a C.P.A. He is past president of the National Association of Cost Accountants. He is an active member of the American Management Association. He is the author of the book, *Basic Standards Cost*, and the author of countless articles in *The Journal of Accountancy*, the bulletins of the American Cost Accountants and the American Management Association, and in *Factory* and other business magazines.

During the war this man was accounting consultant to the War Production Board and to the Navy Department. In this capacity he had a leading part in a most interesting venture in the production of the famous *Green Book*, the explanation of principles determining costs under government contracts, which effectively, if not officially, replaced T.D. 5000.

He is a partner of Peat, Marwick, Mitchell and Company. His subject is "How Acounting Can Help in Running a Business." It is a great privilege to introduce to you Mr. Eric Camman.

HOW ACCOUNTING CAN HELP IN RUNNING A BUSINESS

By Eric A. Camman, C.P.A.,

Past President, The National Association of Cost Accountants;
Partner, Peat, Marwick, Mitchell and Company, New York, New York

Everyone knows that keeping books and accounts is necessary in the conduct of business affairs, but many persons do not know how much can be done through accounting to help in running a business. This phase of accounting goes beyond the mere keeping of accounts, into the art of actually making use in management of the procedures which have to be followed in order to gather the figures, and using them in such a way that they can be of aid in guiding management.

Great progress has been made during the last 25 years in developing the art of useful industrial accounting as an important arm of management. Much has been said and written on the subject, so much that a student now pursuing a course in industrial accounting may get the idea that the field has been pretty well covered and there is little left to be done. This would be very far from the truth. The field has been pretty well covered, but in practice a great deal remains to be done.

Notwithstanding the advances which have been made and the extensive reference material which is available in modern books and publications, the actual use made of accounting in management falls far short of the possibilities. The greater number of business concerns are still being run with less help from their accounting departments than could be made available rather easily. To an accountant in public practice, it is continually surprising how often this is found to be so, and the cases are not all small companies either.

There are two reasons for this condition. One is that the men who make up what we call "top management" frequently have no knowledge of accounting. Their abilities lie in other directions. These men have little patience or time for figures and statistics. Most of them would deny it if you told them that they were not sold on the importance of accounting. Yet in too many cases the kind of information furnished is of the least practical use to them, and it should cause no wonder that they are skeptical. Somehow accountants make it as hard as possible for other men—men who are not "figure minded"—to understand what they are trying to say and to make use of the information they can provide.

That brings us to the second reason for this condition. It is that the acountant does not think enough in terms of top-management problems and speaks too much in the language of accounting, which is a strange dialect. Anyone who has sat in a conference between accountants, on the one hand, and, on the other hand, shop men or salesmen or businessmen of whatever occupation who are not accountants will know that this is so. It takes a long time and a great deal of talk for either side to get its meaning across to the other. This difficulty of expression is becoming recognized. Prominent examples can be found today of attempts to prepare annual reports in a manner so that they can be understood by employees, stockholders and the public. Since accountants are in the minority and since the effectiveness of their services depends greatly upon how they present the information they have to transmit, it is up to them to overcome the difficulty.

The remedy for the two conditions is that the accountant should learn to think and speak in the language of those to whom he devotes his skilled services, and top management and the public in turn should give the accountant the recognition, the means, and the encouragement to do so.

Today I am happy to have the opportunity to talk to you on the philosophy rather than the technique of industrial accounting. I intend to talk about the *why* rather than the *how*. The latter—the technique—deals with the details of procedures and with accounting principles. I shall talk very little about these. I shall devote the time instead to the philosophy which underlies all of our efforts, and the objectives or ends toward which we should aim, from the viewpoint of business management rather than of accounting. If we can keep these objectives and ends clearly in mind and apply our abilities in their direction, the results of our work are bound to be of greater constructive value. If they are lost to sight through obsession with technique, the objectives may never be reached and the ends may never be realized.

This has happened time and again. The consequence has been that executives despair of getting the help they need through accounting channels and seek it by other means. The impression has been created that accounting is necessarily cumbersome, involving a lot of system and too much red tape, the less of which the better. Too often this impression has been justified through overemphasis upon technique.

I do not mean that technique is not important. It is. The methods must be economical and efficient, the procedure must be sound, and the figures must be correct. The point I wish to make is that these features alone are not enough. They are of the greatest use if they are directed to the major purpose of solving the problems and lightening the burdens of management.

In the dictionary, philosophy is defined as "the love of wisdom as leading to the search for it." This definition comes nearest to expressing what I have in mind. In business management questions continually arise for decision. Many things enter into the making of wise decisions, but a basic one is reliable and timely knowledge of the facts and factors.

On this point a conversation I had some years ago with the vice president of a large steel company is recalled vividly. We were engaged in setting up a budget and planning procedure, striving for a certain profit position over a period of years. In discussing the program the vice president told me frankly that he had no great faith in paper planning and budgeting, that in the last analysis the attainment of the profit position sought depended upon the judgment of men who knew the steel business and upon their guessing the right way at the right time. He said if they guessed wrong, all the budgets and accounting in the world could not alter the result.

I agreed with him that knowledge of the steel industry, experience and ability in the management of his business were paramount. But I asked him whether he believed that if capable executives were furnished with accurate factual data a month or six weeks sooner than they now were able to obtain them, in such a way that they would make a right decision when otherwise they might have made a wrong one, and if this happened a number of times throughout the year, might this not amount to saving many thousands of dollars in each case and perhaps a tidy sum in the aggregate? He agreed that this might well be so. And so it turned out to be. His company reached the goal set, and accounting helped in bringing this about.

This conversation illustrates the substance of my message. One of the things we are trying to do through industrial accounting is to facilitate the making of wise decisions. Decisions are often quite easy to make if the facts are known in time. At any rate they are easier to make than they would be without such information. The hard thing usually is to find out what are the facts and set them down in their relative order and proportion. This is the task of the accountant. His job is to get the facts and to present them so that the man in charge of a department of the business may see clearly where he stands, where he should go, where he has to do something to come out right, and what are the pros and cons of alternative courses. That is a big job. The accountant should see it is a big job;

likewise, should the executives who are top management see that it is a big job.

In thinking about this meeting today and how to bring out this philosophy better than by general statements, I sought some graphic form of presentation. The trouble with general statements is that they can be made easily in words with which most people will agree, yet no one will come away with a more real idea of how to carry into effect what was said than they had when they came. My thought was to draw a graphic chart showing, on one side, the various areas or departments of management in a modern business, and, on the other side, more or less in parallel, the various functions of accounting that can be brought into service.

It soon became clear that such a graphic chart would grow pretty large and would require a sheet of paper the size of a county map to cover all the territory. Therefore, I prepared instead two tables of captions or major headings. The first one (Table A, page 59) contains an outline of eight major areas of management which exist in any manufacturing business. These will be familiar to you all. The activities shown are those usually found. They are briefly stated, which is enough for our present purpose, and you will understand that they can be further subdivided at will. They are intended only to define, in a broad way, the scope of our interest.

The second table (Table B—Major Accounting Functions, pages 59 to 61) contains an outline of some of the major accounting functions, or services, which can be rendered in aid of management, in each of the areas shown in Table A. Table B again is capable of expansion at will. It is not meant to be complete. In fact, it was prepared by just jotting down the items as they came to mind. When I had reached the number of 21 separate and distinct items, I decided that was enough to take up all the time available for this part of your program and stopped looking for more items. Table B is intended only to be indicative of the avenues along which accounting can help in running a business. Each of these avenues may have any number of side streets, but here are the principal roads.

Under each caption in Table B a few cryptic notes are given in the form of questions. These are asked to bring out the nature of the problems and the nature of the thinking in the various areas of management. These, too, are incomplete and more questions no doubt will occur to you. Enough are shown, however, to serve as a check list and to stimulate your thoughts along these lines. A book could be written on the basis of this outline, but that cannot be done this afternoon.

Let us now consider each of the items listed in Table B representing the functions or services through accounting which may be made available to help in management in the major departments shown in Table A.

I—Administration

1. Forecasts—Budgets

In order to manage any going concern successfully it is obviously necessary to have plans. These plans may range all the way from simply trying to do better than last year to highly refined, long-distance programs looking years into the future. In the former case of the greatest simplicity, past performances become future guides. But running a business effectively now is not as easy as this. The trend under our complex economy inevitably must be more toward definite planning and forecasting.

Budgeting is a method for setting down such plans and forecasts in dollars and numbers of things—quantities—and numbers of men to produce them. For many years hard-headed, practical businessmen were apathetic about budgeting. Some of these leaders were violently opposed to budgets as impractical, illusory, and even nonsensical. But gradually these views have changed and the use of budgets of many kinds has expanded, so that they are now generally accepted as good practice. Indeed, it is a fair statement that no business of any size can be run to the best advantage today without budgets and forecasts.

Budgets in business are merely plans set down in concrete figures, as I have said. They are quite different from budgets as they are used in governmental, muncipal, or institutional affairs. In these, budgets mean essentially appropriations, within the limits of which administration must be confined. In business, however, a budget is not such a restrictive instrument. It represents a plan from which deviations are not only permitted, but are expected. Administration here is free to proceed without restriction, and administrative endeavor is turned toward controlling the deviations, improving the favorable ones and curtailing the unfavorable ones.

Surely we need not argue at any great length that in order to run a business with security we must have plans and we must have budgets. The simple cycle of having a product to sell, getting orders for it, buying materials and making it, then delivering it to the customer and collecting our money, has expanded into many activities at every step. In fact, each step has grown so complex that it has become necessary to separate and specialize the management of an enterprise into many branches or subdivisions of control. Yet they all have to be coordinated and held in balance, which is no small problem in proportion.

Here the accountant can render services of great value by furnishing information, charting the courses, observing and reporting progress and position, and pointing out trends.

2. *Trend Summaries*

From what has been said it is clear that it is important to know where we are, how fast we are going, in what direction, and whether a change in rate or direction is desirable. Forms of accounting reports and statements which merely show the current position are not of much aid in management. Reports which show the position now in comparison with the position at another time (such as this month in comparison with last month, or this year in comparison with last year) are somewhat better, but still quite inadequate for the needs. Such comparisons are meaningless—indeed, they may be positively misleading—unless and until they are anlyzed and interpreted. The reader must first make mental reservations in the figures before him to eliminate the effect of altered conditions. These do not appear on the surface but are reflected in the figures. The reader must make such reservations both with respect to the present position and to the previous position. This is truly a laborious task for which the executive has not time or inclination.

Recognition of these difficulties has led to the presentation of data in the form of trend summaries. In this type of report, figures on the same activities are set down for successive periods. For example, if the figures are weekly, they are set down side by side for each week for a period of, say, 13 weeks. If the figures are monthly, they are similarly set down side by side for a period of 12 months. If the figures are yearly, they can be set down in the same way for any number of years.

In this arrangement it is possible to read almost at a glance the rate and direction of the trend in any activity. It is immediately seen whether the progress is good or bad, and whether it is very good or very bad. When such figures are read in conjunction with others, representing the budget or expectations on the same activity, the picture is even more complete.

The performance and the trend on one activity can be seen and measured against those on another. Maybe they should run together or in parallel. If rates of pay go up, it seems logical that labor effectiveness should also go up. Often it does not. In running a shop department, the rate of spending (for departmental expenses) should normally tend to be within the rate of running (production load). If the rate of spending goes up and the rate of running goes down, high costs or losses are inevitable. Control in management is largely a matter of maintaining the proper proportions between numerous activities all going on at the same time. The use of trend summaries can be of great help in achieving such control.

II—Finance

3. Financial Statements

Perhaps the most usual service expected of the accountant in industry is the furnishing of reliable monthly financial statements. This is so obvious among his duties that one might almost pass the subject by without comment, yet there are things to be said and there is much room for improvement. In some cases monthly financial statements are not made up because of a mistaken belief that they would be misleading. Sometimes a business is highly seasonal in its operations and it is felt that intermediate reports would give a distorted picture. This need not be so if the budgeted results are shown for comparison with actual performance for the partial period.

In other cases the monthly statements furnished are little better than estimates, subject to adjustment at the end of the year when an inventory is taken and final balances are struck. In still other cases the financial statements are so late in forthcoming that much of their usefulness is lost.

Monthly statements should include more than just a balance sheet and a profit-and-loss account. They should include comparisons with projections of probable income and outgo. How much money is going to come into the till? What are our more or less fixed obligations which have to be met in cash during each month ahead? Payment of pay rolls, taxes, declared dividends, expenditures for construction, for research, and so forth, cannot be deferred. How much money will we have to borrow from time to time, and when can we repay such borrowings?

Financial statements also should contain pages of informative comments and a summarized description of what is being done in the provision of major reserves. It is true that the amounts of such reserves appear in the balance sheet, but merely setting down an amount does not tell the story. How are the amounts derived? Are they sufficient? For example, we have reserves for depreciation. Does anyone know whether they are adequate, in the broad sense, remembering that replacement costs have risen far beyond the original costs of acquisition. Under these conditions replacements may not be chargeable entirely to depreciation reserves. It may mean that profits are not stated realistically, or it may mean that prices are improperly based.

In a similar manner the story should be told about any other reserve of sizeable amount, showing how it is derived, what it is for and how the money is to be spent. At each meeting of the Board of Directors questions of policy may arise involving expansion or contraction, entering upon new ventures or abandoning others. These are important matters, the influence and effect of the decisions upon them will appear in the future. The directors cannot carry in mind all the factors which should be considered. They must have before them complete and comprehensive, but at the same time simple and compact statements and projections in order to discuss proposed plans intelligently.

4. Internal Control

Provisions of internal control are an accounting service of which the scope is sometimes underestimated. When an outside independent public accountant comes in to make an examination, one of the things he looks into carefully is the manner in which this function is observed and performed. Internal control means good business housekeeping. It means more than just setting up checks and balances against irregularities. It means seeing that things are done in accordance with instructions and that approved practices are carried out. It means seeing that good organization is maintained. It means taking care of all the property of the company, guarding against preventable losses. It also means covering unforeseeable or unpreventable losses by sufficient insurance against all kinds of risks.

Internal control in this broad concept means the difference between an orderly, well-managed business and one which is run along disorganized, loose and inefficient lines. Given equal talent and opportunity in other respects, which business of the two do you suppose will be the more profitable and satisfactory one?

5. Taxes

The subject of taxes belongs in this listing. The preceding speaker has already covered this subject extensively and ably. I shall confine my comments to the statement that the tax aspect of business actions and contracts should never be overlooked. I do not mean that the industrial accountant need be a tax expert, but he should have competent tax advice on all matters. It may be a mistake to assume no tax effect will appear. The accounting problems of modern taxation are intricate and call for specialized knowledge. Even the timing of transactions may be important. For instance, under the old Vinson Act an appreciable difference in recoverable profits might occur, depending upon whether a contract was completed in one fiscal year or the next. The present tax laws also have carry-over provisions.

III—Sales

6. *Market Analysis*

The industrial accountant is an analyst by training. The study of markets—where customers will buy our products, which customers will buy the most, which will keep on buying, and what kinds of things we make will they buy—are subjects for analysis which can lead to market improvement in accomplishment. Market analysis can point the way to the most effective application of sales effort and expense. Who is better qualified than the industrial accountant to participate in this study and to gather the necessary data from which to reason the answers to these questions? And other questions? For instance, assuming we are a manufacturing concern, what are the channels through which we should distribute our products? Should we sell wholly through distributors? Should we sell partly through distributors and partly to retailers? Or should we sell to distributors, to retailers, and enter the retail field ourselves?

There are companies successfully dealing through all three channels. Other companies find it better to confine their sales through certain selected channels. These are questions of policy with which management must deal. They are also the questions which the accountant who would serve management must keep prominently in mind in gathering his information.

7. *Price Structure*

The problems of pricing are many and varied. Prices are subject not only to economic forces of supply, demand, and competition, but also to federal and state laws. The cost of the thing we make to sell is only one factor among many which enter into the fixing of a price. I do not mean that costs are not important. In the long run we must recover costs and have a profit left over. But cost alone is seldom the determining factor. If it were, small customers could not buy our products except at high prices.

The price structure as between customers must be carefully set so as to avoid discrimination under the Robinson-Patman Act. It may be desirable sales policy to grant lower prices to customers who buy large quantities, but any such scale must be set so that it will not work out to unduly favor one customer against another who may be in competition with him.

Another price problem is: where is our break-even point? What is the level of volume which must be reached under a given price schedule before all costs can be covered and profits can begin to be earned for keeps? The three factors of price, volume, and cost are interrelated. If they are held in the right proportions, profit ensues. The problem is to find and maintain these proportions.

The accountant can render able service in this area of management. He can compute tables of discounts in such a way that discrimination is avoided. He can make calculations showing the probable outcome of any given combination of the three factors of price, volume, and cost. He can tell where losses end and profits begin. He cannot make dreams come true and he cannot secure profits. But he can be of material help in their realization by computing the likely results of alternative courses to guide the making of decisions.

IV—Production

8. *Cost of Production*

One of the branches of specialization which has undergone a rapid advance is that of cost accounting. Cost accounting in one form or another is generally recognized to be of great value as a means of control and guidance. This is evident from the numerous articles and the books which have been written on the subject. The literature also deals with various techniques and practices. However, as I have asid, I do not propose to enter upon a discussion of these. I would rather talk about the reasoning, the objectives of cost accounting, and about the causes of high costs.

The ascertainment of the cost of an operation or a product is a relatively minor feat. To tell an executive or department head how much a cost is does not suffice. He wants to know why. Why is it so high? The answer probably is that among other things material has gone up, labor has gone up, and overhead has gone up. But this answer is no answer at all. He knows that these things have happened. The real question in his mind is: what can we do about it? To find out we must get at the underlying causes, and for the time being lay aside the language of figures.

Is our manufacturing management efficient? Do we have the right tools and equipment? Enough factory space? Where are the weak spots in our organization? Some of the difficulties encountered today are attributable to the aftermath of the war: material scarcities, increased price levels, higher wages, high indirect expenses, production slow-down, etc. Some of these are extraneous conditions and other are due to habits and changes in attitudes which have grown out of the strain of the war years. We cannot do much about the extraneous conditions, but we can turn our attention to many other things within our reach about which we can do something to improve operations.

One of the directions in which great gains can be made is that of inventory control, production planning, and production control. These are interrelated and are comprised in the general term "production control." In many cases high costs and low output are caused principally by poor planning, poor scheduling, and poor physical control. Indeed, I have seen cases in which the word *poor* would be euphemistic and the word *inept* or chaotic would more properly describe the lamentable lack of production controls.

One of the most immediately effective ways of offsetting higher costs arising from increased prices and increased wages is to step up production. The greater output must be brought about not by hiring more men or buying more machines. It must be done by turning out a greater volume with the same number of men and the same equipment, if costs are to be brought into line. To accomplish this we must make use of all possible means of smoothing out and expediting the flow of production.

Such a program calls for long-range procurement planning and production control. Procurement planning means purchasing foresight. Production control means having balanced inventories, advance planning for manufacture, scheduling for machine and assembly loads, and dispatching for uninterrupted flow of materials and parts.

Without these essential features of control, efficient manufacturing and assembling are impossible and labor is indeed laborious. Products cannot be produced for lack of missing parts. Parts cannot be furnished for lack of balanced inventories. Balanced inventories do not exist because of inadequate procurement or production methods. Then in desperation resort is had to the deployment of a large force of stock chasers to hunt for missing parts and to push them along so that assembly can be completed. Hurrying these parts along pushes others back. The inevitable results of this vicious cycle are utter confusion, excess inventory, low production, and high costs.

The industrial accountant can do a great deal to remedy such situations. Planning is part of his work. So also are the devising of ingenious forms and practical procedures for keeping the necessary records. The process is merely accounting in another form. Instead of keeping books and ledgers, it deals with orders, cards, charts, and records kept in quantitative terms of hours and pieces, requirements versus capacity to produce. A variety of office machines and devices are obtainable. The accountant can combine his procedural abilities with the technical knowledge of the engineer and the production know-how of the shop man. The three together can bring order out of chaos, or come pretty close to it. It has been done.

9. Cost Reduction

The problem of cost reduction is one of the most pressing ones facing management now. Price increases cannot continue indefinitely. Even with increased prices, high costs threaten seriously to cut into profits. In one case recently studied, we found that in the year 1946 gross profits—for the sake of emphasis, I repeat, *gross profits,* before any expenses beyond manufacture—would have been entirely wiped out had it not been for price increases which were made effective in that year. Indications were that further price increases would meet with sharp customer resistance. It was clear that there was only one practicable course to pursue, namely, cost reduction.

I have already mentioned one way to reduce costs, which is by increasing output. Other ways are to find the elements of cost which are too high and over which we have some power of control. These will be found usually among the indirect manufacturing expenses known as overhead. During the war years such expenses leaped out of all bounds because of the drive to get out production without regard for expense. The end of that surge has not been followed by a corresponding reduction in expense.

Losses through spoilage, rework, and excessive tool costs are other elements of cost in which reductions can be made. The way to attack these problems is to organize for the task. The nucleus of such an organization again can be found in the combined efforts of the accountant, the engineer, and the shop man. Under their direction a small staff can be set up to devote full time to the pursuance of a definite cost-reduction program.

V—Shop Management

10. *Inventory Control*

I have already touched on the need for inventory control. Basically this calls for procedure for knowing what is on hand and available for use. This requires a record that will show reliably what is in stock, and a place or places in which to keep stock so that it will be there for use when wanted. The principle is as simple as it sounds. Its realization in practice, however, can only come about by carefully and ingeniously devised procedure, so that the two simple things can be done while at the same time paper work and handling are kept within economical limits.

11. *Labor Effectiveness*

The subject of labor effectiveness is a delicate one. It enters upon the field of human relations in industry. It deals with incentives, with performance, with pay, and with facilities, and as well with health, comfort, welfare, safety, and congeniality. All of these and more enter into labor effectiveness. The abilities of the accountant can be brought into constructive use in this important concern of management. I do not mean that the industrial accountant shall become a personnel director. He is, however, (if he is not, he should be) in reasonably close touch with the employees in the shop who makeup the group we refer to as "labor." He keeps their time, he makes up their pay, he reports upon their activities and productiveness. Perhaps he has a hand in setting the basis upon which their earnings are calculated. Indeed, the effectiveness of the accountant in industry depends in no small degree upon recognition of this human relationship.

According to the newspaper headlines, rates of pay are set by collective bargaining. Colective bargaining seems to consist of demanding certain hourly pay and prerequisites in exchange for a number of hours of work. The productivity of the work and the effectiveness of labor are submerged in these headlines, most of the talk being about a decent wage, cost of living, security, and working conditions. Yet in the final reckoning there must be just proportions between rates of pay and labor effectiveness. It is vital for management and labor to find out what these proportions are, and to reach and uphold them.

12. Indirect Manufacturing Expenses

Measures of cost reduction from wartime high levels have been mentioned. These are a subject distinct and different from the regulation of shop indirect costs, which in normal times has always presented problems of control. With the exception of fixed charges, the larger part of shop overhead expenses come closely under the jurisdiction of the departmental foremen. These expenses may run into substantial sums yearly.

The problems of their control have two aspects, namely, (1) ascertaining how much it is proper to spend for each item of expense at varying degrees of operating load, and (2) how to enlist the interest and active help of the foremen in keeping expenses within these limits. The function of the accountant is to furnish the information mentioned in the first bracket. It is the function of the works manager or factory superintendent to promote the cooperation mentioned in the second bracket.

13. Production Control

I have already described the need for adequate production control procedures in my remarks under "Cost of Production." There is little to add to what was said except repetition and amplification, for which we have not enough time now. I might say that the administration of production control, and the departmental staffs therefore, generally are made a part of the shop management organization. However, as I hope I have made clear, the controller or industrial accountant has an important service to render, and he should be a part of the directing force. He is by training and ability the logical one to establish the necessary procedures and records to furnish the information which is required.

14. Tool Cost Control

There are many cases in which the cost of tools runs into a large sum of money. In such cases excessive breakage, wear and tear may well be items for attention in a cost-reduction program. If frequent breakages occur because of faulty material or wrong application, not only is tool cost increased but production is reduced. The flow of work is curtailed. Special pay allowances may have to be made to direct labor because workers cannot earn what they should under these conditions.

15. Plant and Equipment

It is commonly accepted practice that the keeping of suitable property records is within the province of the controller. Aside from this, however, he should also provide complete and accessible information of what is available in the way of productive facilities and their practically attainable capacity. Effective planning is impossible without a knowledge of machine and man and space capacities. Balanced production is difficult to arrange without such knowledge. Where bottlenecks appear, obviously the facilities either must be increased or subcontracting must be undertaken.

VI—Personnel

16. Employee Earnings

As I have said, employee earnings should be regarded in conjunction with labor effectiveness. I might add that beyond consideration of the interrelationship between productivity and earned pay, the full cost of employment should be taken into account. The full cost of employment comprises expenditures other than the dollars that actually go into the employee's pay envelope for the work he does. These are for social security, taxes, vacation allowances, welfare expenses, sickness, accident and health provisions, compensation insurance, and pension-plan allotments. When such items are counted up they may run as high as 50 cents on every dollar of wages paid. They are definitely as much a part of the cost of employment as wages, and should be so regarded and treated in the accounts.

17. Job Evaluation

Job evaluation is a term which has been newly evolved. It is not a new idea. Fifteen or twenty years ago it was called salary classification.

Perhaps the reason for the change in name is that it had its beginnings in application where large staffs of salaried workers were employed, whereas in recent years its application has expanded rapidly to wage-earning groups. This is attributable to the growth of unions and union relations. Employers and unions as well as labor benefit from a fair and equitable job evaluation program and policy.

The process of job evaluation is one of analysis. It means a careful study and breakdown of the nature of the work, and the required effort and skill or training, for each job. The breakdown must be thoroughly made to reveal all the characteristics present.

After this analysis, the next step is one of classification. Equal requirements are given equal ratings and differing ones are given varying weights, so that upon summation reasonable relationships can be found between different jobs. Equitable rates of pay are then established for each job according to this grading. The object is to do away with discriminatory or inequitable pay and to establish fair compensation for each position according to its demands.

Actually, more is accomplished through job evaluation than merely setting equitable rates of pay. Greater satisfaction on the part of employees is one advantage. The enumeration and classification of jobs and the weighting of requirements also brings with it a knowledge of the opportunities which exist and the skills which may be acquired. This tends to arouse employee interest and leads to advancement. In turn these heighten morale. They also encourage and develop future leaders from within, and that leads to the building of a strong organization.

18. Employee Profit Sharing

Employee profit-sharing plans of one kind or another have been put into effect through the last twenty years and some have been newly adopted. The number of concerns using them, however, is small. The infrequent use of such measures is not due to lack of interest in them so much as to their inherent difficulties. Most of the plans in use have been specially fashioned to fit individual cases and could not be applied generally. But the thinking and the tendency still are in the direction of devising some equitable and practicable means for labor to share with management and capital in the profits arising from their joint efforts.

Under one of the recent plans which seems to be working satisfactorily, employees of three years' standing receive dividends when dividends are declared to stockholders. The amounts paid to employees are computed on a formula: the employee's average annual earnings, divided by the book value of the company's stock, yields a number of presumed or equivalent shares on which his dividend is based. It is not a bonus plan. Its features tend to promote a sense of responsibility and ownership, continuity of service, and an interest in the welfare of the company.

19. Security

Recognition is found of the need for, and the benefits of, pension plans by the adoption of such plans by representative companies after long and careful consideration. They are designed to supplement federal and state social security provisions.

Other security features are being devised or talked about. For instance, the Standard Oil Company of New Jersey has printed a list of six or seven causes for which an employee may be discharged by his superior. This list is hung in all departments of the plants of the company. The list of causes are the only ones on which an employee may be so discharged. In all other cases, grievances or necessary adjustments are carried on up through channels for adjudication by higher authority, if I may use a pet Army term. This is really outside the field of accounting, but as an accountant I am interested in the instruments of good management.

VII—Development Engineering

20. Project Control

In the area of development engineering there is an important service to be rendered by the accountant. Development projects cost money. Usually they cost a great deal of money. The money is ordinarily spent under an appropriation made for the purpose. An appropriation may be authorized for $5,000 or $50,000 or $100,000 for a particular project, to make a working model, or to complete a pilot machine, or to carry on certain experiments. Once the appropriation is obtained the engineers set to work. Engineers on such projects, of course, are inventors and enthusiasts, and they improve on their ideas as they go along. The improvements may cost more.

Here is where the accountant can help in controlling such expenditures. He can keep track of what is being spent, and at frequent intervals he can call upon the engineers to render an estimate of percentage of completion. The accountant can compare with the original appropriation the percentage of progress and the percentage of money already spent. Thus he can give forewarning of what is happening. If the engineers report they are half of the way along in their project, and the accountant finds they have already spent two thirds of the authorized monies, somebody ought to start thinking about how much more may be needed to finish the undertaking.

VIII—Procurement

21. Procurement Planning

I have already spoken about procurement planning under production control. By procurement I mean something more than purchasing. The term "purchasing" is too narrow to define the larger job. Procurement implies more to me than the mere issuance of purchase orders. It means a full knowledge of all the sources of supply and a good understanding of the capacities of, and the demands upon, such sources. It means a close contact with the top personnel of all such sources. It means a knowledge of markets and market trends. And it also means a fairly reliable knowledge of probable requirements for a year or more ahead.

Here is where the accountant comes in. He is the one who can furnish the procurement officer with data on requirements of principal materials. Such data should be based not only on past usage and backlog of orders received, but should take into account also projections of sales planning, in order to foresee what may be needed to meet orders not yet received.

Conclusion

To sum up, we have traversed, rather quickly and sketchily, twenty-one items of major accounting functions or services in management. We have seen how they can be put to use in eight major areas or departments of management.

These observations are mere glimpses of the opportunities which exist. The possibilities of benefit which lie in these opportunities are great and well worth striving for. The precise nature of these possibilities, and the shaping of your efforts, will vary in each particular case. My job today has been done if I have succeeded in arousing your interest and your enthusiasm in the constructive work there is for you to do.

FUNCTIONS OF ACCOUNTING IN INDUSTRIAL MANAGEMENT

A—Major Areas of Management

I—*Administration:*
- Advance planning and policy determination
- Executive decisions
- Legal counsel

II—*Finance:*
- Maintenance of working capital —credit
- Security of investment
- Taxes

III—*Sales:*
- Distribution—markets
- Prices
- Lines
- Public relations

IV—*Production:*
- Volume
- Quality
- Cost

V—*Shop Management:*
- Inventories
- Labor
- Manufacturing expense
- Production
- Tools
- Methods
- Plant and equipment

VI—*Personnel:*
- Employee relations
- Employee welfare

VII—*Development:*
- Engineering
- Experiment
- Research on products

VIII—*Procurement:*
- Contact with sources of supply
- Long-range planning
- Purchasing—follow up

B—Major Accounting Functions

I—Administration

(1) *Forecasts*—Budgets:

Where do we want to go?
How fast?
What conditions do we have to meet?

(2) *Trend Summaries:*

Where are we?
How fast are we going? Ahead?
What change in course is indicated?

II—Finance

(3) *Financial Statements:*

Have we enough money to meet our obligations:

(a) to employees?
(b) to creditors?
(c) to government?
(d) to stockholders?
(e) to stay in business?

(4) *Internal Control:*

Are we taking proper care of all our property?
Are we sufficiently insured against all risks?

(5) *Taxes:*
Are we paying proper taxes—not too much, not less than we should pay?
What may be the interpretation, tax-wise, of major policy decisions?

III—Sales

(6) *Market Analysis:*
Where will customers buy our products:
- In greatest volume? — What kind?
- In continuing quantities? — At what price?

(7) *Price Structure:*
Is our price system right:
- As between customers?
- To meet competition?
- How about the Robinson-Patman Act?
- Which sales are profitable?
- What is our break-even point? What are our marginal costs?

IV—Production

(8) *Cost of Production:*
How much does it cost to make the things we sell?
How much of high cost is attributable to:
- Manufacturing management?
- Methods and equipment?
- Planning for production control?
- Selling and distribution problems?
- Extraneous conditions, e.g., inability to get materials, war aftermath, etc?
- Weaknesses in organization or personnel?

(9) *Cost Reduction:*
Which elements of cost of production are too high?
What are we going to do to bring them down?
When?

V—Shop Management

(10) *Inventory Control:*
What have we on hand and in sight?
Is it available where needed in time?
Where and why do our scrap losses occur?
How much re-work do we do?

(11) *Labor Effectiveness:*
How efficient is each man? Each day? Cumulatively? How good is each group (or production center or department) of men, or, in other words, how good is their leader?
What incentives for good work do we provide?
What facilities for good work do we provide?

(12) *Indirect Manufacturing Expenses:*
What are they?
How are they running each week in relation to manufacturing load?

(13) *Production Control:*

Does our method of production control consist of issuing shop orders, period? Are foremen, superintendents, works managers, and vice presidents merely glorified stock chasers in ascending scales? Do we rely on shortage lists instead of planning?

Do we know what production control means?

(14) *Tool Cost Control:*

Why does it cost more for tools than expected? Hard iron? Poor material? Somebody else's fault? If so, whose or what? Are we going to keep on suffering this way? Or do something about it?

(15) *Plant and Equipment:*

What have we in the way of facilities?

Where are they?

What is their productive capacity?

VI—Personnel

(16) *Employee Earnings:*

Are employees paid a good day's pay for a good day's work?

Are employees giving a good day's work for a good day's pay?

What is the total cost of employment?

(17) *Job Evaluation:*

Are basic rates of pay equitable for all jobs?

Do our employees understand what opportunities lie before them? Do we give them any definite goals, besides payday, to work for?

Where are our future leaders to be found? Are we building them?

(18) *Employee Profit Sharing:*

What are we doing to give our employees a sense of responsibility, of ownership in a common enterprise conducted by labor and management?

(19) *Security:*

Do we offer our employees a real feeling of security:

In employment?

In reward of accomplishment?

In retirement at old age?

VII—Development Engineering

(20) *Project Control:*

How are development projects getting along?

How much is being spent? How much more will be needed?

VIII—Procurement

(21) *Procurement Planning:*

What are our requirements by kinds in each quarter for a year ahead?

FOURTH SESSION

FRIDAY, MAY 16, 1947—7:00 P. M.

DINNER SESSION

Deshler-Wallick Hotel

Chairman:

WALTER C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University*

Address: "The Role of Accountancy in Prosperity and Peace"

EDWARD B. WILCOX, C.P.A.; *President, The American Institute of Accountants; Edward Gore and Company, Chicago, Illinois*

THE ROLE OF ACCOUNTANCY IN PROSPERITY AND PEACE

By EDWARD B. WILCOX

President, The American Institute of Accountants;
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Three stone masons at work were approached by a stranger who asked, "Why do you labor?" Said the first, "For hire." Said the second, "To build a wall." But the third answered, "To create a temple." Some of us engaged in public accounting might answer that we work to make a living, and I am sure that would be an honest answer. But, if public accounting is indeed a profession, that answer is too narrow. One of the differences between a business and a profession is the relative importance of rewards and service. The object of commercial enterprise is reward. We call it the "profit motive," and it is justified in the belief that benefits to the community follow from it; but the seeking of reward is the prime motive. A profession, by way of contrast, seeks first to serve, and it is the reward which follows.

There is something of this belief inherent in the nature of our professional organizations. The American Institute of Accountants, organized primarily to unite the accountancy profession in the United States, has, among its other objects, the safeguarding of the interests of public accountants. But these interests have been safeguarded not by seeking rights, privileges, and immunities for members, but by promotion and maintenance of high professional and moral standards, by assistance in the maintenance of these high standards for the certified public accountant certificate in the several states, by providing examinations, by improving accountancy education, and by developing accountancy itself. The principal activities of the Institute center around these purposes. This organization does not measure the interests of accountants in terms of what can be had for them, but in terms of how useful they and their services can be made. It is rather a stern order we have joined, dedicated to the public interest. If rewards follow after service, it is not because of the acquisitiveness of our organizations, but rather because of the quality of service they expect us to render. And so we ought to answer the question why we labor, at least as well as the second stone mason, who worked not only for hire, but to build a wall.

Our usefulness and, therefore, our existence depend on public confidence which can only be maintained if it is deserved. To the well-known similarity of love and hash can be added professional public accounting: you have to have confidence in order to enjoy it. As in many other fields, high purposes and enlightened self-interest lead to similar courses of action. Whether it be vainglory, devotion to service, or just good business, we are committed to one of the most rigorous ethical concepts in the world. We must be independent of those who employ us. If we abandon this, we abandon both ourselves and those who depend on us. The essence of what we have to offer is independent integrity; and when we forget this, we fall into those failures which betray both ourselves and the public we serve.

We might, and sometimes do, indulge in words of self-congratulation on the extent of merited confidence which we enjoy. And there is some proof of merit in the fact that widespread confidence does exist. But we are more apt to dwell on this than are others, and it is not in what we say or believe that virtue lies, but in what others say and believe. These others do not always see us as we see ourselves. They do not understand accounting, nor realize that we are or can be as independent as we must be. Yet when a failure occurs, they blame us. And sometimes failures do occur—failures in auditing, failures in reporting, in adherence to generally accepted accounting principles, even sometimes in genuine independence. True, these are like the crimes and the divorces which make the newspaper headlines and tell nothing of the great body of law-abiding citizens and successful families, characteristic of our people. But the few failures are important because of the fact that they attract attention out of proportion to their number. And they can damage the confidence which is so essential to the usefulness of professional accountancy.

There is an impressive and reassuring body of activity designed to maintain and raise professional standards of accounting. Since 1939, the Institute's committee on accounting procedure has labored to narrow the areas of inconsistency which have limited the usefulness of financial statements. Similarly auditing procedures have been studied, expanded, and defined. Standards have been set up, and consideration given to the extent of disclosure which should be required to justify those familiar words in accountant's reports "fairly presents," and the extent to which an accountant may sign his name even if he does not use them. Thus other areas of inconsistency are being narrowed. The pronouncements of the profession on accounting and auditing standards should be and are the most authoritative and respected judgments on their subjects, and the fact that they come from an organization of national scope leads to nation-wide uniformity. In making effective these improvements in fiscal reporting, the hand of the professional accountant has been strengthened by the prestige and backing accorded him through the reliance placed on his reports by the Securities and Exchange Commission, and its insistence on proper standards and procedures. If our own purposes are indeed to serve, rather than to seek rewards, then the Commission has helped us in attaining them. Both the pronouncements of the Institute and the requirements of the Commission may seem to be burdensome dicta, but the truer view is that they are supports and guides to better professional service. The principal obligation which they impose is that they must be taken seriously.

It is time to remind both the profession and the public that the development of auditing and accounting standards and principles is important. The present scale of activities was undertaken because, in their absence, the need for them was clearly imperative. It is unfortunate that people seem to appreciate the value of what they lack more than the value of what they have; and so we may not all keep alive a burning appreciation of the great things we are doing. In fact there are a few, both within and without the profession, who grow restive about bulletins on auditing and accounting. One view is that the judgment of persons preparing financial statements should not be hampered by rules. Those who hold this view forget that narrowing the areas of inconsistency is essential to the usefulness of financial statements, and that those areas under consideration are basic and do not involve the application of judgment to specific cases. Another view is that everybody concerned should be accorded a right to vote on pronouncements. Those who hold this view have obviously failed to visualize the utter impossibility of achieving, by means of nation-wide town meetings, any approach to uniformity in the difficult and technical fields of auditing and accounting. The two views seem to invoke ideals of freedom and democracy, but they would be destructive of the great progress which has been made and which continues to be made in advancing the art of accountancy.

But all this is not to say that public accounting has been made easy. There have been set up no substitutes for proficiency and judgment. The improvement in standards means that auditors' examinations cannot be performed by a process of blind groping, rather the need to be informed and alert has increased. Our rules are increasing and it is a job to keep up. We may be justified in feeling a little strange in our own house, as Alice felt when she stepped through the looking glass and the Queen of Hearts explained that "here it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that."

We have been running pretty fast. In addition to the technical improvements I have mentioned, we have strengthened uniform examinations, investigated selection of personnel, sharpened our concept of independence, and developed an appropriate and effective code of ethics. The purpose of these things is to raise the standards of the profession, to eliminate the incompetent and the unfit, and to prevent failures which would undermine the confidence on which our profession rests. Because this is so fundamentally important, it follows that the profession must have the support of regulatory legislation, at least as to its function of furnishing expert opinions on financial statements. It is in the public interest that such practice should be restricted to certified public accountants, because they have demonstrated a fitness justifying reliance. However, the immediate establishment of such restrictions in states where legislation has not already been accomplished, could mean only one of two things: either noncertified public accountants now in practice would be deprived of an existing right to make a living, or they would have to be granted C.P.A. certificates by waiver. The former is both legally and humanely impossible, and the latter would be disastrous. Therefore, the Institute has recommended state legislation restricting the verification of financial statements to certified public accountants and to others who are already in practice, with the provision that future licenses will be issued only to certified public accountants. This recommendation is conceived in the public interest, and has the approval of an overwhelming majority of the members of the Institute. As it becomes embodied in state laws, the dependability of properly qualified public accountants, subject to control under law, will become increasingly apparent, and the profession will have added to its prestige and usefulness.

The area of that usefulness is almost unbounded. Service to management through skill in income taxation, and system and control methods contribute to efficient business operation. But more important are the opinions of independent certified public accountants—so essential to the assurance of creditors and investors. And their assurance is essential to our entire economy. For so long as confidence in fiscal reporting is maintained, creditors and investors will consistently support an economy which is fundamentally sound. But a collapse of confidence could result in economic disaster.

Continued support by credit and investment requires dependable business ethics, and their maintenance is the function of the accounting profession. We are the high priests of the business world. We are its conscience. It is too easy for public accountants to forget this, and there is no way for them to be reminded of it in their daily work. But I commend to you the testimony of any one of our number who has left the public field to enter a commercial organization. At the very least, the shift of emphasis from service to profits comes to him as a shock.

A prominent businessman once complained to me that public accountants didn't help their clients. He told me of a brother-in-law who, he said, was the soul of honor. This brother-in-law owned a foundry. In 1941 he foresaw increasing income-tax rates, so he raised his inventory at the end of that year 50 per cent over actual count, thus reporting some of his 1942 profits for income taxation at 1941 rates. My friend maintained that that was just good business and was incensed because the firm's accountants refused to have anything to do with it. I remember asking him if he thought it would have been equally good business if the statement with the inflated inventory had been submitted to him with a request for a loan. He thought I was being rather disagreeable.

This is not to say that businessmen are typically dishonest. Business ethics in our country today are comparatively high. But it is primarily to us in the accounting profession that the function of maintaining business ethics is entrusted. Let it be noted that the conscience of business which we hold in our hands has been fostered and supported by a free economy. I am not sure just what a free economy is. I have heard that it is where nothing is free and nobody can practice any economy. But certainly free enterprise is not marked by criminal tendencies. Individuals in it may chafe at restrictions, as who does not, but jointly there is in it an awareness that everything must be kept upright and square. That is the part of free enterprise which is the particular responsibility of the accounting profession. If we fail, who will take our place? Let me quote a part of Christ's "Sermon on the Mount": "Ye are the salt of the earth; but if the salt have lost its savour, wherewith shall it be salted? It is thenceforth good for nothing but to be cast out and to be trodden under foot of men." That could have been said of us.

In the past these responsibilities of the accounting profession have been within the familiar framework of management, investors, and creditors. We have provided a service in which persons in these groups, having conflicting interests, may, and do, place mutual reliance. There is coming increasingly to our attention another group which needs this same service—labor and labor unions. These organizations, once small and underfinanced, needed protection, as did our infant industries of earlier years. Possibly it was quite proper at one time to excuse labor unions from disclosing a precarious and vulnerable financial condition. Now that they are grown large and powerful, there is no more need to foster them by special privilege than there is need of tariff protection for our giants in industry. Adequate financial responsibility and publicity must be required of all unions. On the other hand, if they are to function effectively, they must have the information they need. Financial statements of employers, designed primarily for investors and creditors, do not provide this information. It must be furnished by financial statements designed especially for this purpose. There must be full and useful disclosure of fiscal information both by and to labor organizations.

This fact has been recognized by many corporate managements which have undertaken to keep labor informed by providing it with financial statements of company operations. These statements are necessarily limited to the operations of single enterprises, and cannot, therefore, indicate the adequacy of general wage levels. But they serve a purpose, and it is important that they be kept honest. Generally such statements are more useful if they are brief and simple, but brevity can lead to obscurity. One consideration to be remembered is that in large corporations there has been a trend toward relatively fixed rates of common stock dividends, so that the real issue in division of revenues from production is not so much between owners and employees, as between management and labor. This is a consequence of the well-known divorce between management and ownership. Similarly in smaller, closely held companies, net income does not always represent the reward of capital because the owner-managers may wish for obvious income-tax reasons to take as much as they can in the form of compensation, and as little as possible in the form of dividends. Therefore, an income statement purporting to be informative to labor but which lumps together all management salaries, bonuses, and labor costs, and then shows that the remaining profit is small in relation to this total, might not be honest. It may be even worse if the comparison is made with net profit after deducting income taxes. It is an important duty for those who have responsibilities for such financial statements to see that this kind of misrepresentation does not occur.

It is pertinent to ask who will have this responsibility. Labor will not accept management reports. It is no more likely that management will admit union auditors and accept their findings. Some agency of the government might be formed to prescribe accounting principles and to audit and report, but if that were to be done, all hope of subsequent selection of fair, competent, and independent auditors would be gone. Whatever political bias dominated, the governmental auditing agency would color its findings. This agency would be fastened on both labor and management, and neither, nor both together, could shake it off if it proved unsatisfactory. It therefore seems obvious that the preparation of reports for the information of labor should be in the hands of the accounting profession. Possibly some public accountants will regard this new area of responsibility with more apprehension than eagerness, but surely they will guard their integrity and independence no less jealously when labor places reliance on them than they do now. And the accounting profession will have met a new challenge, and will have moved forward again in its unbroken tradition of increasing usefulness, adapted to constantly changing demands.

But labor is not the only field in which independent certified public accountants can expand their usefulness. We could not only prepare, but certify, the correctness of income tax returns, thus saving costly Bureau audits and delays in the ascertainment of tax liabilities. Chartered accountants do it now in England and Canada. It would require sturdy independence and integrity in a new area, but that is no reason to shrink from it. We could, and indeed some of us have aided cooperatives in solving their financial and accounting problems. If we don't like cooperatives, that will require independence of prejudices, but, again, that is no reason to shrink from it. Similarly we can be, and many of us have been, of service to the government in audits of its departments and corporations. If we don't approve of governmental corporations, or if we have a distaste for municipal audits, we may shun this work, but personal bias is an inadequate reason for limiting our usefulness. If we are truly a profession, service will come ahead of not only profit, but of prejudice.

Above and beyond the services which we as independent certified public accountants can render in the conduct of our practices, there are ways in which our profession can be of service to the community in which we live. Important as are our expert opinions on financial statements to the maintenance of credit and investment, and possibly to the solution of problems of labor, the implications of financial statements are broader still. These broader implications were recognized by the Committee on Accounting Procedure of the American Institute of Accountants in its first bulletin issued in 1939. The committee said, "The test of . . . corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not from that of any one group of interested parties." If we are to judge financial statements from the standpoint of society as a whole, we must recognize that they do more than simply report the fiscal history of business enterprises. They actually affect the economy of which those enterprises are a part. And they can affect it for good or ill. They have been accused of augmenting boom-and-bust cycles by overstating profits during booms and understating them during depressions, thus overstimulating business confidence when it was already excessive and correspondingly depressing what confidence there might be when it was already at a low ebb. This sort of thing can happen. For example, inventories on a first-in, first-out basis might bring high costs into low income periods and low costs into high income periods, thus exaggerating both. That is one reason why accountants have given much time and study to other inventory policies which will more clearly reflect current relations of costs to revenues. Similarly the need for cleaning house in financial statements is generally more apparent in bad, rather than good, periods, and this fact tends to bring accounting recognition of losses into years already reflecting depressed conditions. That is one reason why accountants are apt to resist charges to income amortizing good will in the years when its value appears to be declining. The selection and establishment of accounting principles which will result in a fair presentation of income without socially harmful exaggeration or understatement is one of the responsibilities of citizenship which the accounting profession recognizes as its own. That is why consistency has replaced conservatism as a prime virtue in financial statements. It is why the Committee on Accounting Procedure of the American Institute of Accountants has recommended recognition in income statements of income-tax provisions which are closely related to the reported income. It is a reason behind the quest for an established method of stating results of operations for the period covered by an income statement, unaffected by items related to other periods or to no period at all. In its attack on these problems, the accounting profession is contributing to economic stability through the effect of financial statements on society as a whole.

In the familiar and often painful field of income taxes, we are aware that defects and complications in laws and regulations weigh heavily on business enterprise and tend to divert business leadership from the problems of efficient organization, operation, and production to considerations of tax avoidance. The impact of fundamental tax policies on our social and economic structure involves difficult conflicts of objectives. We crave both simplicity and equity. We seek to encourage small businesses and to relieve small incomes of tax burdens to avoid hardship, to combat the increasing centralization of economic power, and to increase consumer demand in our markets; yet we wish to avoid burdensome taxation on larger incomes because, without the possibility of the accumulation of capital, new enterprises cannot be undertaken, and without hope of reward, they will not be undertaken. The resolution of this conflict will not come from the application of any simple formula, but only from that form of genius which is the capacity for taking infinite pains. Obviously we should seek to find the optimum points in the various conflicts which will best contribute to sound and lasting prosperity. This is the purpose of the Institute's recommendation of a nonpartisan tax commission for the simplification of federal tax laws and the establishment of a consistent income tax policy. It is the purpose of efforts by volunteers from the profession to achieve simplification of income taxation, even though such simplification might conceivably reduce their own incomes. It is service by the profession as a whole, to the community in which it lives.

All this is more than working for hire, like the first stone mason. It is even more than the stolid and peasant-like building of a wall—presumably because someone said a wall should be there. In the contributions which the accounting profession can make to the stability and prosperity of our economy, and hence to peace and human happiness, we can truly help to create a temple—the temple of the community in which we all live.

When we were at war, less than two years ago, we realized the interdependence of people throughout the world. We knew then that there must be happy and prosperous conditions for all people, that there must be friendly and helpful relations between them, and that our own peace and security and prosperity and happiness depended on it. We knew for a time that the brotherhood of man was the most practical and necessary of human ideals. Now there is danger that we may forget. There is danger that disillusionment and war fatigue will lead us into a sort of trance while we drift into the next depression and the next war. There is the same danger against which John Curran warned our fathers near the close of the eighteenth century:

> It is the common fate of the indolent to see their rights become prey to the active. The condition upon which God hath given liberty to man is eternal vigilance; which condition if he break, servitude is at once the consequence of his crime and the punishment of his guilt.

Happily for us in this country, one of our greatest responsibilities as citizens of the world, and one that lies close to the field of public accounting, is the maintenance here at home of a sustained and stable prosperity. Certainly there should be no conflict in this between joy and duty. But it is no longer a primarily domestic concern only of our own that we be prosperous. We have become the trustees of our own prosperity for the benefit of others because the stability, the prosperity, and the peace of the world depend on it. And greater than any riches we may acquire will be our own participation in the enjoyment of that peace and security. The unprecedented extent to which this is true raises considerations of domestic economy to the level of responsible world citizenship.

One reason for this is that the United States has become the world's great creditor nation. This fact puts foreign countries greatly at our mercy. A good creditor can contribute to the prosperity of his community; a bad one can destroy it. It is something that we have granted loans, supported foreign currencies, and aided in rehabilitation abroad. I hope we will contribute to the reduction of trade barriers. But it is also essential that we maintain a stable economy at home so that our credit policies do not become intermittent and capricious as a result of boom-and-bust cycles. And it is likewise essential that we maintain a prosperous economy at home so that there may be in our markets an effective demand, not only for our own products, but also for foreign goods such as will enable our debtors abroad to prosper and pay us.

Even more fundamental than credit policies, is the moral force which this country can exert in a world desperate in the grip of fears born in war and nurtured in its aftermath. This will be a force for freedom and democracy if our own economy leads to peace rather than war. Therefore, it must truly and effectively serve our people and leave no grounds for discontent here where the seeds of destructive doctrines may take root. We cannot protect ourselves from unsound doctrines by smothering them or fulminating against them, but we can be immune from them if our own economy well serves our people. And if we maintain a successful economy, we can be tolerant of others, secure in the certainty that nothing succeeds like success. We may be sure that the eyes of the world are on us now. Our friends abroad look to us for leadership, and trust us to demonstrate that economic collapse is not the price of peace. If we can do this, we can build a happier world than we have known.

It is a great temple we have an opportunity to create. We as certified public accountants cannot build it alone. But we can contribute to it through services to business management—services which aid production through financial statements increasingly useful to society as a whole, through services which will bring labor controversies a step nearer to sound and fair settlements, through public services in the fields of taxation and governmental accounting, and through zealous guardianship of that conscience of a free economy which is our especial trust. These are sound practical contributions to a stable and prosperous economy. Each one of us can make them. We can make them by increasing our proficiency, by maintaining genuine independence, by exercising that kind of care in auditing which is the foundation of merited confidence, by sincere observance of the code of ethics of our profession, by generous public services in the field of our competence, and by exerting our influence in the direction of economic justice and high standards of business ethics. These are things each individual practitioner can do; they not only add to his own prestige and profit, but also reach far out in bringing to the world prosperity, security, and peace.

FIFTH SESSION

SATURDAY, MAY 17, 1947—10:00 A. M.

Commerce Auditorium

Chairman:

VICTOR Z. BRINK, *Vice-President, The American Accounting Association, New York, New York*

Address: "The Controller's Relation to Company Policies"

JOHN H. MACDONALD, *Administrative Vice-President, The National Broadcasting Company; President, The Controllers Institute of America, New York, New York*

J. ROBERT MYERS, *Budget Officer, The National Broadcasting Company, New York, New York*

Open Forum

INTRODUCTORY REMARKS

By Victor Z. Brink
Vice President, The American Accounting Association,
New York, New York

Now, as we come to this Saturday morning session, I think we might briefly take inventory of what we have done up to this point and where the morning session fits into the total program. Around this central theme of "The Accounting Aspects of Business-Policy Determination," we have thus far heard from various specialists or authorities who have given us the slant of a particular specialized area.

First, we heard from Mr. Coleman Andrews and we were given much insight into the relationship of accounting to the management of public affairs. Then Mr. Arthur Hald explained the relationship of the work of the internal auditor to this great problem of business-policy determination. In the afternoon, we were made acquainted with some of the tax implications of these policy determinations and saw how tax considerations might influence the making of those policy determinations. Then from Mr. Eric Camman we received further information regarding the role of industrial accounting in connection with these business-policy determinations. Last night we looked at the problem from the viewpoint of the public accountant. While Mr. Wilcox's paper dealt primarily with the professional responsibilities of the public accountant, indirectly we felt the impact of the public accountant's work on the making of business policies.

This morning it seems to me we round out the program in a very nice way by coming to the controller who in the business organization stands, or at least should stand, for all of the constructive pulling together of the fruits of accounting to make it useful to management in running their business effectively. Surely the controller, if he is awake to his responsibilities, has the greatest opportunity of all to influence and mold and assist in the making of business-policy decisions.

We had hoped to have with us this morning Mr. John H. MacDonald, who is president of the Controllers Institute of America, as well as vice-president in charge of finance of the National Broadcasting Company. Unfortunately Mr. MacDonald suffered an accident and is confined to his home.

We are, however, fortunate that he has able assistance in the person of Mr. J. Robert Myers. Mr. Myers is budget officer and assistant to Mr. MacDonald. He is a graduate of Johns Hopkins University. He spent seven years as an internal auditor and inspector in the National Broadcasting Company in various financial and statistical capacities prior to his appointment as budget officer. We are indeed happy to have with us this morning Mr. Robert Myers.

THE CONTROLLER'S RELATION TO COMPANY POLICIES

By John H. MacDonald

Administrative Vice President, The National Broadcasting Company; President, The Controllers Institute of America, New York, New York

Presented by J. Robert Myers

Budget Officer, The National Broadcasting Company, New York, New York

In his talk on "The Controller's Relation to Company Policies," Mr. MacDonald planned to discuss the accounting, budgeting, and cost-accounting procedures at the National Broadcasting Company, and to outline the way in which they are used for financial control and as an aid in establishing company policies.

As a background, I should like first to say a word about the organization of the National Broadcasting Company. Network broadcasting is a communications service which provides national coverage both for advertisers and for the dissemination of news, information, and educational programs. Time not sold commercially to advertisers, which incidentally is approximately half of the total time we are on the air each day, is filled by so-called sustaining programs which are produced and broadcast at our own expense. The "NBC Symphony" orchestra, the "University of Chicago Round Table," and "America United" are examples of such programs. Our network owns but 6 of the 167 NBC affiliated stations which are interconnected by wire lines for the instantaneous broadcasting of programs. The stations, other than the six, are independently owned and are affiliated with the network under contracts which provide that they will clear time for our program in certain segments of the day and evening. The network acts as the sales agent for its affiliates and the stations are paid for the use of their facilities on network programs.

The network has studio and program production facilities as well as sales offices in New York, Chicago, Hollywood, San Francisco, Washington, Cleveland, and Denver. With the exception of Hollywood, the six owned stations are located in these cities.

The controller's function in NBC comes under the vice-president in charge of finance and the controller, the treasurer, the director of personnel and labor relations, the office manager, and the budget officer report to him. The vice-president in charge of finance is the representative of top management with respect to the financial, labor relations, and personnel functions of the company.

While the operations of the network and the six stations we own are the primary activities of the company, we also have a radio recording business, which makes records which are used exclusively for broadcasting purposes, as distinguished from phonograph records; we are in the International Short Wave Broadcasting business; and last, but by no means least, we are raising the two newest members of the communications family—television and frequency modulation. Since these activities are matters of separate executive responsibility, we also separate them for accounting, budgeting, and management-control purposes.

Our standard account setup, used by all offices, is such that each activity is credited and charged with its direct income and expense items. To use our station in Cleveland, WTAM, as an example, "national spot-time sales," "local time sales," "sales of house orchestra," and other local income associated with the operation of the station are credited to it. Similarly, charges are made to WTAM for operating and overhead expenses directly applicable to the operation of the station, such as advertising agency commissions on local time sales; the cost of the various operating departments, such as program, engineering, sales, and local service departments, rent, depreciation, and other items of local overhead.

Generally, this same procedure is followed with all other so-called activities, i.e., network operations, radio recording, etc. On the expense side direct charges are made for those items directly connected with the activity. This leaves a balance which is somewhat more than half of the total operating and overhead expenses of the company, consisting largely of executive and other general expenses incurred in New York. This amount is then allocated to the various activities on the basis of formulas we have developed. Here are several examples which indicate how we handle some of these allocations.

The national spot-sales department handles the sale to national advertisers of non-network programs and spot announcements. This department is the national sales representative for our own stations and also those of Westinghouse Radio Stations, Inc., the General Electric Company, and the Manila Broadcasting Company. The expenses of this department in our various offices are totaled and then apportioned to the six owned stations on the basis of the percentages of their individual national spot sales to the total national spot sales of the company. The effect of this is to charge the NBC stations a variable commission for obtaining each month's business which is exactly equal to the proportionate cost of obtaining that business, rather than a flat percentage of commission, which would be the method used were the sales handled by an outside representative.

Certain functions of the headquarters' engineering department in New York are performed for the benefit of all the owned stations and for the radio recording and television divisions, as well as for network operations. Expenses of the office of the vice-president in charge of engineering, who directs all engineering operations at the policy level, are in part allocated to the stations on the basis of the percentages of each station's total gross income to the total company gross income. This same basis is used in the case of the administration of other departments of the company which are headed by vice-presidents whose duties include general administration and policy making for their respective operations throughout the entire company.

A different method is used in allocating the expenses of the development and broadcast facilities groups of the engineering department. The development group, as its name implies, is engaged in technical reesarch and the application of improved technical devices to actual broadcast operations. The facilities group is concerned with the planning and construction of new transmitting and studio equipment, as well as repairs and improvements on existing equipment. Expenses of both these groups are allocated on the basis of man-hours of work devoted to those of their projects directly affecting each of the owned stations and other activities. Since there is a continual series of new projects on which these groups are engaged, the allocation percentages are subject to change each month depending on man-hour reports.

Two divisions of advertising and promotion activities, i.e., the office of the director of promotion and the expenses of institutional advertising, are allocated in part to the stations on the same basis as that of the vice-president in charge of engineering, namely, the percentages of each station's gross income to total company gross income. These expenses are incurred for the benefit of all divisions of the entire company. The director of promotion is reponsible for general plans and policies in advertising for each of the company's operating divisions. Advertising classified as institutional features promotion of the National Broadcasting Company as an organization and, of course, benefits all the various operations in the company. Here again we have determined that the most equitable basis for distributing such cost is that of proportionate income. This basis is used in approximately half of the various allocations of general company expense.

An example of the allocation of expense within a single office location is the general office services department in New York which consists of administrative, stenographic, duplicating, central files, and supply and receiving sections. The administrative section is apportioned to each of the other sections in the proportion that the expense of each bears to the total expense. The revised costs of the remaining sections are then charged to each of the activities served in New York on a use basis.

Statements thus prepared for each activity are essentially statistical reports for internal management purposes and are not official statements. Our official statement is a consolidated, condensed form of the operating statement.

The standard account setup and methods of preparing official and activity statements is matched completely by the budget detail and in the preparation of budget statements. The budget function is of great importance to management at the National Broadcasting Company, perhaps in part due to the nature of the business. We are subject to sudden fluctuations of income and even of expense. In practice I think of our budget system as serving the dual purpose of estimate and control. It controls expenses and it also serves very importantly as an estimate of future operations. It is an accounting function in terms of the future used as a tool of management. It is the device through which plans are prepared and then made to work.

Detailed budgets following the account setup are summarized and assembled into the various types of statements prepared by the Accounting Department. In addition to the condensed form of operating statement and the various statements by activities, there are other statements prepared on a budget basis. Future operations are reflected in the form of an operating statement in detailed form by individual departments. The expense budget is also broken down by individual items of expense which is identical with another one of our statements prepared by the Accounting Department. Another statement, also identical in form with one prepared by the Accounting Department, is a detailed statement of all activities, which shows in separate columns total company operations, network operations, owned stations, television, radio recording, and frequency modulation.

Since the physical volume of the complete budget detail in the form it is received is so great and cumbersome, we have developed for management's information quite complete summaries of all operating budgets in booklet form. This detail is broken down primarily by operating departments and within each department are shown annual totals for each item of expense for each of the various operating divisions. The sheet or set of sheets covering each department are, in a sense, cost statements. For example, the sheets covering the Program Department bring together the departmental operating expenses, the costs associated with the actual production of noncommercial programs, such as payments for talent and orchestra, and the various items of income (orchestra sales, income from the sale of sound-effects services, etc.) produced by the operations of this department. The result is what we term the net cost of operations for the department. We do not keep track of the cost of all individual sustaining programs other than to keep memorandum records within the program department of the out-of-pocket costs of certain high-cost programs, such as the NBC Symphony.

Our budget is revised at the beginning of each quarter and these statements are prepared on an annual basis each time the budget is revised, that is, the budget statements prepared at the revision beginning with the second quarter of the year are based on 3 months' actual results and 9 months' revised budget.

I would like now to discuss briefly the mechanics used to prepare the budget. Individual operating budgets in complete detail by accounts and months are prepared and submitted by the operating heads to the budget office in advance of the year or budget period to be covered. When received, they are checked for mathematical accuracy, reviewed and analyzed, and compared with prior periods. In the case of the original budget for the year, we check with the preceding year's actual results. As we revise quarterly throughout the year we not only check on an annual basis with the preceding year, but we check with the previous budget for the same period. Differences are discussed with the operating heads and, where necessary, explanations are obtained. The budgets are summarized into operating-statement form and presented to the management, together with summaries of differences, and explanations and analyses of what has happened since the previous estimate. The budget is then reviewed with management, the various changes being discussed in summary or in detail as interest or importance warrants. Where necessary, department and operating heads are called in for consultation and possible changes in their budgets. After required changes are made, the budget is formally approved and the preparation of the various budget statements is begun.

As I have mentioned, we revise the budgets quarterly. It might be said that this procedure may tend to weaken the controlling effect of the budget. On the other hand, things happen so fast in broadcasting that we just can't afford to wait even as long as three months before taking another look. While we must appraise the outlook constantly, we go through all the mechanics of a complete revision only at each quarter. At the months between quarters we prepare revised estimates of operations for the immediate quarter, taking into account known variations from budgets and changed conditions.

Salary budgeting is a specific problem in itself. We base our salary budgets, as I assume most of you do, on the going rate of the payroll. Each department head preparing a budget is supplied with forms on which to show his salary rate at the beginning of the budget period, provision for increases to be handled in accordance with the company payroll plan or existing union contracts, and provision for anticipated increases or decreases in personnel. To the estimates thus prepared, we then add reserves where necessary to cover contracts under negotiation or anticipated during the budget period.

At intervals, and rather frequently lately, we make a payroll analysis of actual salaries paid to determine the actual cost of increases, turnover, and expansion factors. This provides a valuable check on the elements of salary cost as anticipated in the budget.

Special appropriations are necessary in our budgeting system to cover unanticipated costs arising between revisions of the budget. While we have, of course, a capital forecast, each capital item must be covered by a special appropriation which, if beyond a certain amount, requires the approval of the Board of Directors.

Now that we have a budget, the next thing to do is to make it work. For the purpose of expense control, we prepare at the close of each month's business, comparisons of the budget and actual performance for that month. Detailed comparisons are made for each department and subdepartment and sent to the various operating heads. Where budgets are overexpended —or too far underexpended—requests are made for adequate explanations looking toward correction of the situation. A report of the high points of performance is made each month to management. In addition to the detailed expense comparisons, total operating results in income and expense statement form are compared with the budget each month and variations checked for reasons and correction in future budgets.

Some specific illustrations of the controller's relation to company policy may be of interest. Just now we are starting in the television business. How this new art will ultimately develop is not entirely clear, but we are building a television service and it is going to mean the expenditure of a substantial sum of money for plant and equipment. In order to plan future financial operations, company revenues and expenses have been estimated ahead for two years and results have been coordinated with cost estimates, prepared by the Engineering Department, covering outlays for television facilities. With this basic information, a plan has been developed which schedules capital outlays in accordance with anticipated operating results, minimum cash needs, and satisfactory dividend payments. Management decision on the extent of investment in new facilities and the method of financing were based on this information.

We have a retirement plan which management adopted only after studies and recommendations prepared by the controller and the director of personnel. The decision on the plan finally adopted was based on analyses of plans in use by other companies; trial by application of various plans to our own salary structure and circumstances to determine if needs were met and were within permissible cost; satisfactory means of financing both initial and estimated continuing costs; development of proper administrative procedures and mechanics for operation of the plan. Thus it was the function of the vice-president in charge of finance to study, develop, recommend, and bring to the point of final decision an important company policy.

Salary policies of the company are formulated with the aid of the controller's analysis of the payroll and salaries paid, over a given period. This analysis shows basic salaries, how much has been paid in salary increases, the cost of additional employees, and the effect of personnel turnover. We have made comparisons with salary rates prevailing in other companies and similarly situated businesses. We have prepared analyses of changes in salary rates measured against the cost-of-living index and individual, income-tax rates, and, most important, our salary trends in relation to other cost factors and income. During union contract negotiations, the financial department is actively working with our labor negotiators in checking the cost of various proposals.

The controller's office cooperates very closely with the research department whenever a discussion of the rates and discount structure arises. Decisions to make changes are made only after many alternate proposals based on existing and anticipated business volume are carefully worked out.

The nature of our business is such that we are constantly dealing with very substantial sums in both income and expense. For example, a single client may spend a million dollars a year or even more. Therefore, the acquisition or cancellation of only one program is of great importance.

Similarly on the expense side, the matter of filling a noncommercial time period with an audience-attracting program, produced at company expense, involves a considerable outlay. The cancellation of our clients' programs to carry messages of public importance from the President of the United States, or other public officials, not only results in a loss of revenue, but the assumption of contract payments to the talent scheduled to appear. Over the course of a year, this is a substantial and, to an important degree, an uncontrollable item. Television, with new capital investments and current operating losses, represents millions of dollars.

We must make a constant effort to state a complicated series of related facts simply and nontechnically so that management can understand the situation without detailed study. At the beginning of the year and at each quarterly budget revision, a clear and concise statement of the many changes involved in explaining differences between the operating budget for the year and the past year's actual results, or previous budgets for the same year, requires considerable analysis and summarization.

I have dwelt at some length on the importance of the budget in the controller's relation to company policies and, to summarize, I would like to quote from Mr. MacDonald's book, *Practical Budget Procedures:*

> Although budgetary control has much in common with accounting, it is the writer's firm belief, based on some years of practical experience, that it is much more closely related to management. A budget, to be sure, seeks to project the future in accounting terms. The accounting aspect, however, is only incidental to the main objective which is to plan the work and then control operations accordingly—an activity which certainly is a function of management rather than of accounting.

OPEN FORUM

MR. HERMANN C. MILLER (Ohio State University): I would like to have Mr. Myers tell us what resistance he finds to the acceptance of accounting information when management establishes business policies. To what extent are business executives likely to make their own policies irrespective of the accounting information?

MR. MYERS: Is your question directed more towards the budgeting angles or the actual accounting results?

MR. MILLER: The budget.

MR. MYERS: We have good backing. Over a period of years the executives haven't brushed the budget aside hastily. I have seen it happen, occasionally, particularly if the management is determined for policy reasons—public relations reasons—to go ahead with something. They may feel that they have to do it, and in such cases, we just have to take it. However, as a rule, we don't find much resistance. I think this is due to the state to which the budgeting function has been brought under Mr. MacDonald's influence. He is due a great deal of credit for that.

CHAIRMAN BRINK: I, too, am very interested in the question which Mr. Miller has raised. It seems to me that we have all kinds of existing situations. We have the kind of management which feels that it knows it all and can operate entirely without the accounting aids which are at its disposal. Fortunately, that kind of management is going out of the picture, I am sure, although there are the occasional cases of the executive who by his highly developed managerial sense and dominant personality seems to go through in spite of accounting. I have seen this happen. On the other hand, I think that sometimes the accountant is at fault, too, because he doesn't have the imagination to look beyond the figures with which he is dealing. It seems to me that it is one thing to provide a system which develops information and reports (many of us can do that efficiently), and another matter to take the data which are available and to try to give those data constructive analyses and interpretations which can then be made available to management. The great majority of executives, I am confident, will accept and appreciate the help of the accountant if it is presented with some imagination and appreciation of the needs of management. Personally, I feel very strongly about the possibilities and potentialities of accounting as a real management aid. I don't expect the accountant to take over the captain's helm, but I think he deserves at all times a place as an important junior partner in helping to guide the ship.

Mr. O. Ashler (Cleveland Pneumatic Tool Co., Cleveland): In following up Mr. Miller's question, I thought perhaps a little personal experience in my own company might be of interest because of the fact that it may give someone some ammunition to use sometime. I have served as controller under three successive managements, with one complete change of ownership connected therewith. I served through practically the entire war. We are a manufacturing industry. I suspect that many of you men who are connected with a manufacturing industry have heard the operating departments make the same sort of comments which I am going to quote from our former management. I am thinking now of the problems involved in price setting and estimating. No matter how hard we preached to the former managements telling them that they were not going to be able to keep overhead costs down below what previous experience had shown them to be, or to greatly increase the efficiency of labor, or significantly lessen scrappage, the price-setting policies of the company were very largely set in direct disregard of the controller department's observations which were based on prior experience. The result—well, I don't have to tell you what the result was—highly unsatisfactory at the end of a year.

The present management relies implicitly upon the forecasts of what is going to happen as indicated by the controller department's records of what has happened in similar circumstances in the past, and there has been a complete reversal of our profits as a direct result of this policy. For what it is worth, there you have a direct experience on that particular point.

Mr. Brink: That is very interesting and very helpful, I am sure. I take it that even in your case management doesn't accept blindly the statistical data which you prepare?

Mr. Ashley: They still argue about it, but they finally take it.

Chairman Brink: I think they should argue because, after all, we should have to sell the services of accounting on their merits. Moreover, when we get to presenting cost data based on formulas or arbitrary allocations, there is a real danger that accounting can be oversold.

Mr. Frank C. Callahan (Richard Smethurst and Company, Cincinnati): I'd like to ask Mr. Myers how the actual results compared with the budget forecast, and what he generally considers a reasonable percentage of error.

Mr. Myers: We think that 5 per cent is fairly good and we generally stay within that, but it depends on whether you are talking about income or expense. Those items which are strictly controlled, of course, we are able to estimate very closely. Things that are absolutely uncontrollable, such as the instances I mentioned of putting the President on the air when we have a regular commercial program scheduled, we can only guess at. Generally we come fairly close.

MR. JOHN R. WOOD, JR. (Prentice-Hall, Cincinnati): I have a comment on something which Mr. Hald said. This is an opinion which conflicts with a statement which he made. If I recall correctly, he said that the internal auditor should be careful not to recommend changes in policy or new policies, that he should be very careful not to be involved because if it turned out to be incorrect, then he would be to blame. Now I think that is ducking a responsibility, an opportunity of an accountant, whether he is an internal auditor or an accountant anywhere up the line.

CHAIRMAN BRINK: I don't remember the exact language and it may very well be that Mr. Hald's statement was a little more conservative than one I would make. That whole matter comes up in connection with a number of problems. To start with something more positive, you have the question of the accounting system in an organization. We have had some lively arguments where certain internal auditors would have a systems department as part of their own operation and they would not only recommend changes, but would go in and work out the change. I feed definitely that the internal auditor shouldn't go that far because, if he actually makes the change in the system, he will then have a vested interest in that procedure and he then loses his independence and his objectivity. But certainly he should recommend. Policy is of a little higher level than that and I think I would agree with you that there is no reason why the internal auditor could not make a recommendation for changes in policies, backing them up by the information he has to justify his conclusion. I think what Mr. Hald really meant was that the internal auditor isn't making the decisions or the policies, but he is only providing management with the basis for modifying the policies. Of course, one also has to recognize there that how forceful the internal auditor, or the accountant, can be depends much on what the policy deals with and what are the accounting implications of that policy. Some matters are very definitely accounting, some are borderline, and some are fairly remote. Obviously the closer it comes to the primary field of interest of the internal auditor, or the accountant, the more strongly he can speak; then, it is up to management to make the final decision. I think we are in agreement that there is no reason why the internal auditor, or the accountant, should not make recommendations on changes in policy.

MR. PAUL LANGDON (W. E. Langdon and Sons, Columbus): I'd like to raise a question as to the location of the budget function and where the budget officer of the company of federal agencies should be. It seems to me that some think the budget officer should be entirely divorced from accounting, and we have management engineers and planning officers who seem to think that they should handle the function and the accountant should have very little to say so far as the budget is concerned. In fact, in one federal agency where I was making a survey, the accountant just sat there and they paid no attention to what he did and he paid no attention to what they did. Such situations may be responsible for some of the budgets we have from the federal government. Anyway, I'd like to hear a few comments as to where the budget function should be located. My own opinion is that accounting is directly related to the budget and the budget officer should have something to say about the preparation of accounts.

MR. MYERS: We believe that the budget functions should not be a part of the accounting functions but that it should work hand in glove with it. In our company they are separated in that I report to the vice-president. We have worked out a very satisfactory arrangement. We are always running into situations where new accounts have to be set up for new situations arising, and I have to handle them before the controller does because I must know where to put them in a budget perhaps a year from the time they actually happen. We don't lead the accounting function, we follow it. But where we do run into situations which are new, we have to get together on it to plan, and we usually work it out very well.

CHAIRMAN BRINK: This is more a matter of organization, but I recall that the Controller's Institute usually take the position that budgeting is a fundamental part of the controllership function. I take it from your description, Mr. Myers, that that is not the case. The controller functions more as a chief accountant, would you say?

MR. MYERS: To some extent. The controller handles the accounting, I handle the budgeting, and we both report to Mr. MacDonald, vice-president in charge of finance.

CHAIRMAN BRINK: I think that is quite typical of many business situations where the names do not mean exactly what one would read into them at first glance. I had already formed the conclusion in my own mind that, despite the title, the vice-president in charge of finance was the controller in the broad sense as we read about it, at least in publications of the Controller's Institute. It raises one other organizational question in my mind: Where does the treasurer fit into your organization?

MR. MYERS: The treasurer, controller, director of personnel, and budget officer report to the vice-president in charge of finance. The treasurer is not responsible to the controller in our company, or the man we call the controller, but he is responsible to the vice-president in charge of finance. The vice-president is what might be called the general business manager of the company and he also has other top management functions.

CHAIRMAN BRINK: It reminds me that Metropolitan Life Insurance is just revising their booklet on the functions of the controller. I am sure you will all be interested in seeing it when it comes out.

MR. MYRON KEM (Dayton Rubber Company, Dayton): Would you briefly draw a distinction of what in your opinion is the difference between the relationship of the controller and the internal auditor in the determination of company policies?

CHAIRMAN BRINK: That is a somewhat controversial subject. The Controller's Institute would take the position that the internal auditing is one of the functions of the controller; in fact, it is so listed in their list of responsibilities. In the Institute of Internal Auditors there has been what you might call a majority group who feel that the internal auditor, if he is really going to do an effective job and have the proper independence and objectivity, should be independent of even the controller and should be directly responsible to top management; that is, to at least a vice-president. Some go so far as to feel that the internal auditor should be directly responsible to the Board of Directors. The Detroit-Edison Company is illustrative of a situation where the by-laws provide directly that the internal auditor is to report to the Board of Directors. Personally, I favor middle ground. I think the correct principle is that the internal auditor should be responsible to an officer of higher rank than the head of the activity or department which he is reviewing. He should be at least on a par with the chief accountant. I am using "chief accountant" in the sense of the man who is directly responsible for the accounting activities, not controllership in the broad sense. If the chief accountant and the internal auditor are responsible to a man named the controller, and if this individual is really a top management executive, I see no harm in that. The important feature is that the internal auditor should be independent of the particular areas which he is attempting to appraise and review.

Obviously management will fix the rank of the internal auditor's service when they place it in the organization chart. If they make him responsible only to an executive of lower rank, then his range of service is thus limited. If the National Broadcasting Company had an internal auditing department and the internal auditor was made responsible to Mr. MacDonald as vice-president in charge of finance, I think that would be the most satisfactory situation.

Mr. Oliver W. Seifert (Deloittle, Plender, Griffith and Co., Cincinnati): I would like to inject a different thought and get Mr. Brink's reaction. We have been talking a great deal about the accounting aspects of business-policy determination, but nobody has exactly defined business policy. Could you give us some illustrations of its classification and tell us where it is determined along the line.

Chairman Brink: About the best answer I can give to that is for you to read Arthur Hald's paper in detail. While that paper was a little hard to understand at first reading, Mr. Hald did outline the ranges of business policies. These levels start from policy problems which exist at top level and range to local policies.

In the case of N.B.C., Mr. Myers mentioned such policy decisions as how far and how fast they would go into the development of FM and television. I suppose it would be a major policy if they decided to acquire 36 stations instead of six stations. Those would be policy problems at the top level. Then, as you go down through the organization you get to policies at a lower level. As Mr. Hald pointed out (and he was thinking of the Consolidated Edison Company): How the customer in that particular branch office should be dealt with. Maybe some of those policy determinations are not strictly accounting. Perhaps whether you should route all the people in one door and out another door isn't. The accounting aspect is more remote, but there may be other policy determinations, such as how often they should bill in this area, or the detail that should be put on the individual statements—matters which have very significant accounting implications. So I think you have got to catch the policy at whichever level you find it and then try to appraise the accounting implications or accounting aspects of that particular type of policy decision. In broad principle, I would say that a policy decision is any determination which affects the manner in which that company is going to do business, internally or externally.

SIXTH SESSION

SATURDAY, MAY 17, 1947—2:00 P. M.

Commerce Auditorium

Chairman:

GEORGE W. ECKELBERRY, *Department of Accounting, The Ohio State University*

Address: "Examples Illustrating the Use of Accounting in Business-Policy Determination"

JOHN W. PAYNTER, C.P.A.; *Assistant Controller, The J. L. Hudson Company, Detroit, Michigan*

JOHN R. WOOD, JR., *Prentice-Hall, Inc., New York, New York*

HARRY R. EDWARDS, C.P.A.; *Controller, F. and R. Lazarus and Company, Columbus*

HARRISON W. WILDER, C.P.A.; *Ernst and Ernst, Detroit, Michigan*

MYRON S. KEM, C.P.A.; *Assistant Secretary and Chief Accountant, The Dayton Rubber Manufacturing Company, Dayton*

INTRODUCTORY REMARKS

By George W. Eckelberry
Department of Accounting, The Ohio State University, Columbus

We have brought back a number of our former students who have gone into public accounting practice and into private accounting. It seems to be entirely fitting that they should come back to participate in this general discussion on the use of accounting in formulating business policies. We are extremely proud to claim these men as our alumni. We are proud to claim others of you in the audience, too. We try to keep in contact with our alumni as closely as we can, but some get lost. We have on our bulletin board outside a list of graduates of our department who have passed the C.P.A. examination. We feel that that list is not complete. We wish you would keep us informed of your changes, your addresses, and your progress. We want to keep our records as accurate as possible. We want to know where you are and what you are doing.

Twenty-five years ago, the Department of Accounting was quite different from now, as far as the faculty is concerned. The curriculum was about the same. I don't think that we have made many changes in the courses. The courses are taught much better than in those days, of course. I even taught a course in cost accounting back then, and I went from cost accounting to senior problems, business statements, and intermediate accounting. We have a division of labor now which permits each member of the faculty to work within a given field.

When the department was created twenty-five years ago, there was a great deal of opposition to it on this campus. Some of the people in the Arts College viewed with considerable alarm the fact that bookkeeping was being given academic respectability. They thought that the university had no business teaching such subjects; in fact, there was considerable opposition to the organization of the College of Commerce. The dean of our college at that time, Dr. G. E. Hagerty, saw the possibilities of the accounting profession and he insisted that accounting be set up as a separate department and that it be given definite professional standing on this campus. All of us owe a great deal to Dr. Hagerty's vision and to his determination to put accounting in a separate department. Shortly after the department was created, we were fortunate in adding to our staff Prof. Howard

Greer. Professor Greer later went with the Institute of Meat Packers and is now with the organization of Kingan and Company.

Our department, as you saw last night, has had a number of chairmen through the years and I think that that has probably been a very good thing for it. I think that we are fortunate in having so many men in the department who have the administrative point of view and understand some of the administrative problems. I think that has been a very prominent factor in what success we have had.

With the exception of two, who are with large department stores, the five men who are going to talk this afternoon come from different fields. Our first speaker is Mr. John W. Paynter of the Class of 1932. At the present time, Mr. Paynter is the assistant controller of the J. L. Hudson Company. He has had years in public accounting experience as a C.P.A., and we'd like to hear Mr. Paynter discuss some examples of the use of accounting in business-policy determination. Mr. Paynter.

THE DEPARTMENT STORE CONTROLLER'S PART IN BUSINESS POLICY

By JOHN W. PAYNTER, C.P.A.

Assistant Controller, The J. L. Hudson Company, Detroit, Michigan

The business policies of a department store, like any other sound business enterprise, are finally decided by top management, generally the corporate officers or the Board of Directors. These policies, once laid down, must be administered by the next immediate echelon of operating personnel consisting of the merchandise manager, the general superintendent or store manager, the publicity director, and the controller.

During the prewar and war years, management looked to the controller principally for the solution of technical accounting and credit problems, routine report and statement preparation, store system affecting control procedures, internal auditing, taxes, and government regulations. While these things are just as important as they always have been, other phases of the controller's function have become much more important; in fact, have attained ranking equal to that of the more customary control division problems.

If the controller is to carry his full share of the management load, he must, in addition to finding more economical methods of performing the control functions effectively, work closely with the merchandising, operating, and sales promotion members of management in order to be in a better position to perform constructive services for them. Now, more than ever before, an effective job and satisfactory results in the other divisions are dependent upon the tools with which they are supplied to do the job. Tools in the form of effective reports issued on an earlier schedule, adequate and accurate interpretations, special analyses and aids for the effective control and reduction of costs are all necessary to the welfare of the other divisions of the business.

This change in the control function has been taking place gradually and is not a result of the war and of postwar problems. It is the result of increased demands by all branches of the management. If this change had not come about through the needs and requests of other branches of management, it would not have been accepted willingly by them and would, therefore, have been far less beneficial to the business.

One of the major problems in retailing today, from the controller's viewpoint, is that of adequate merchandise controls. During the past few years, merchandise controls were discontinued in many stores, but not in ours. Because merchandise was scarce, buyers were eager to purchase almost any type of commodity, and in some departments, sales and turnover were entirely governed by the availability of forward stocks.

This situation has changed rapidly. Today in a large number of the merchandise lines, salesmen are again on the road, calling on the buyer, with adequate quantities available for almost immediate delivery. Other lines of merchandise will gradually come into adequate supply and in the not-too-distant future supply will again generally equal the demand.

Merchandise controls, properly developed and adequately maintained, when mixed with a little common sense and sound judgment, can accomplish these things:

1. Prevent under-buying when demand for an item is growing
2. Forestall over-buying when the demand has reached its peak or has begun to decline
3. Lower markdowns because over-buying was forestalled
4. Increase turnover because inventory investment will not get out of hand
5. Reduce interest costs
6. Provide specific information of many kinds and types which cannot be obtained in any other manner.

In our organization, the Control Division has a staff of approximately two hundred people engaged in doing all merchandise clerical functions, including the maintenance of merchandise controls on a day-to-day basis for the merchandising and buying personnel. These controls are kept as simple as possible and might not be what a special-service analyst of the accounting profession would recommend or install for his client.

They fall into three general groupings whereby each line of merchandise may be analyzed and controlled by price line, color ratios, manufacturers, size scales, model ratios, fabric ratios and pattern ratios.

One type shows the physical inventory on hand at the beginning of a period (a week, two weeks, or a month, depending upon the need), adds to it the receipt of incoming merchandise, and arrives at "sales" by subtracting the quantity of merchandise on hand at the close of the period as determined by a physical inventory.

In many of our selling departments, especially Ready-to-Wear, the posting of sales is done from the stubs torn from price tickets. If the department is featuring a special promotion, the posting may be done hourly throughout the day of sale; otherwise, the work is completed on the following day. In other departments, sales analysis is done manually from tissue copies of the saleschecks on the day after the sale. In still other departments, actual perpetual inventories are kept. This method applies to such merchandise lines as men's clothing, furniture, electrical appliances, and certain types of houseware of large unit value housed at remote warehouses.

These records are maintained in areas immediately adjacent to the selling floors and are available at all times to the merchandising personnel. When the buyer goes to market, pertinent information from these records goes with him. If he is to be in the market for any length of time, the information will be forwarded to him at frequent intervals. A buyer who has access to proper merchandising records has a marked advantage in the market. His purchases are planned in ratio to prior experience and future planned sales. All of the elements of good merchandising have been properly analyzed and he knows the answer to the following questions before making his firm's commitments to manufacturers:

1. How many dollars he will spend
2. How many units he will buy
3. What price lines he will buy and how many units in each
4. Planned sales
5. Current inventory
6. Planned receipts of merchandise.

We believe that the management of our firm, when furnished with proper merchandise-experience figures, can intelligently plan future inventories, sales, finances, and policies.

Another important problem of the retail store controller is the control of expenses. Since it is customary to measure these as a percentage of sales, the amount of the rise has been concealed by a lowering of percentage ratios. Reviewing the general average for department stores as set forth in the *Harvard Report*, it is noted that with a sales gain in 1945 of 105 per cent over 1939, total expenses increased 61 per cent. The major portion of this increase is in pay-roll costs which showed a rise of slightly over 77 per cent. All other expenses increased about 43 per cent. Similar figures for the year 1946 have not as yet been released, but we know, based upon published statements of a partial list of stores, that they will show a substantial increase over 1945. While all this is true, percentagewise, the cost per sales transaction has been steadily climbing. If we are faced—and everyone in the retail field believes we will be—with a decline in the dollar amount of the average sale and fewer sales transactions, or even the same number of sales transactions, our profit potential will rapidly disappear because wage rates are frozen on a high plane.

Fortunately, department store operations afford an excellent basis for the establishment of standards of performance for workers. Based upon experience records of the number of transactions completed by each department and the number of employees required for past years, we set employment quotas on a monthly basis. These quotas must be followed by the department supervisors.

Recent increases in individual wages and salaries make it impossible to control pay-roll costs by the reduction of dollars paid to employees. The alternative, then, is to increase efficiency and production to the point where the required work can be completed with a fewer number of employees.

To this end, we have established, within the past ninety days, an inventory of personnel skills of the eight hundred employees of our Controller's Division. This inventory is based upon the employee's education, work experience, hobbies, and personal desires to do a particular job or type of work for which he feels he is most qualified. With this information, we expect to correct malassignments resulting from wartime conditions and assign personnel to the job which affords the greatest opportunities for the use of his particular skills and a possibility for advancement. Experience has proven that a satisfied employee is by far the best producer.

Proper training of employees is also a factor in reducing pay-roll costs. Reference and procedure manuals, setting forth the detailed operations of the various accounting and credit departments, are being prepared for the use of new employees as well as employees being assigned new work within the department. Members of the controller's staff have taken an active part in the training program of other divisions of the store, pointing out the close relationship between their work and the work of the accounting department.

In an effort to reduce other operating expenses, we are constantly seeking new improvements in equipment, furniture, fixtures, methods, and procedures. Very little of the present furniture and fixtures used by our accounting and credit personnel is of the conventional office-type design. Most of it was designed and built by us to meet our requirements for accomplishing a more efficient operation with the least amount of lost motion or exertion.

It is with a great deal of enthusiasm that our organization is beginning a long-range program of work simplification. The Control Division is the first of the operating divisions of the store to begin such a program. We are now taking movies of specific accounting operations which involve equipment, personnel, and methods.

The first movies will be very detailed and will show all parts of the operation, including machine operations, hand movements, handling of records, etc. These movies will then be shown to the employees of the particular department for study and suggestions. Supervisors will then study them for operations which might affect other departments.

Simplification in equipment or procedure resulting from the employees' study of the film will be made and then the operation will be rephotographed. After the second film is shown and studied, the simplified procedure, with any necessary minor revisions, will then be put into effect.

We feel confident that this program will assist us in reducing our operating costs. Just recently, we saw a check-cashing operation photographed by a store which has been engaged in a similar work-simplification program for approximately two years. Included in their film was an operation, identical to one in our store, which had been simplified as a result of their original filming but which we were still doing the same old way. The following morning, a change in our business policy was made to give effect to the simplified procedure. This resulted in improved customer service and less handling on the part of the accounting personnel.

Many of the strict accounting technicians here this afternoon may have the feeling that what I have said has very little, if any, bearing upon the subject of accounting and its relation to business policy. Based upon textbook theory, I might be inclined to agree with them. However, through everything that has been discussed here runs a thread of accounting techniques. The points of emphasis have been the need for carrying such techniques through to the point of benefit to every branch of the business. There has been an attempt also to talk of speed—shorter time lapses between the occurrence of an event and the recording and reporting of that event—and finally there has been an attempt to tell you that accounting, at least in an organization such as ours, is a process of seeking the best manufacturing techniques to enable us to produce a fast, dependable, and low-cost tool which has a very positive effect on shaping business policies because it is not a dusty historical record over which to hold postmortems, but instead it is a live-current force from which such policies can be created.

CHAIRMAN ECKELBERRY: Thank you Mr. Paynter.

Our next expert has been on our program before. We are glad to welcome him back to this platform. He is Mr. John R. Wood, Jr., of the Class of 1931. Mr. Wood is now sales executive for Prentice-Hall, Inc. Mr. Wood.

EXAMPLES ILLUSTRATING THE USE OF ACCOUNTING IN BUSINESS-POLICY DETERMINATION

By John R. Wood, Jr.
Prentice-Hall, Inc., New York, New York

For my several examples of the use of accounting in the determination of business policies, I want to go back to my experience with *Time* and *Life* magazines, and particularly the March of Time Newsreel, since it was only this year that I joined the organization which you know as the leading publisher of tax and labor information.

These examples fit directly into the three fields in which I consider the use of accounting can be most valuable in the determination of business policies. These are:

1. Market analysis
2. Tax results on alternative operating procedures
3. Personnel relations.

In these phases of business, the accountant has the greatest opportunity to demonstrate the importance of his contribution to good management.

A motto I've always followed is "Make your accounting do double duty for you." By that I mean, get operating facts and data at the same time you do your accounting.

Market Analysis

At the March of Time we have a new product, a specially created newsreel feature. I had a fairly clean, simple accounting problem here, for we received from our distributor, RKO, the customary report of each sale of each picture to each theatre. During the year that meant about 100,000 invoices. It was easy to set up the monthly credits for income, and the regular accounting data, but I went a step further and followed that motto, "Make your accounting do double duty."

With the same records and staff I developed sales data: What proportion of the play dates were week day and weekend? Were circuit or independently owned theatres? Were city, suburban, or small town? Thus, the accounting department was also working on sales; and soon, instead of being sniffed at as bookkeepers, we became mighty important to those sales people. Through double-duty accounting, we were digging up facts which they didn't know. Needless to say, it wasn't long before that accounting was definitely being used to determine operating policies.

Another example of this market-analysis work, accomplished by the accounting department, developed in the selling of Technicolor pictures during the Hollywood strike at the Technicolor plant. With only 20 per cent of the usual number of copies of a film available, the problem was: Who would get those copies? Who would do without? The accounting department determined this policy because it could select the theatres where the greatest gain in revenue could be had by using color.

Don't overlook opportunities to obtain market analysis or product analysis out of your accounting.

Taxes and Their Determination of Operating Policies

During the war, *Time* and *Life* magazines had the problem of insuring a supply of paper; so, in violation of a 25-year company policy and tradition, the paper buyers bought a paper mill. Then developed the problem of how to direct its operations. The accounting department played a major role in the decisions on how to establish the authority and the responsibility to be given to the various department managers. Here is how that happened.

It seemed probable that *Time* would eventually revert to its old policy of owning no paper mills. We also knew from our tax studies, that a better tax position could be established if this mill could be made an operating division of the parent company, instead of a wholly owned subsidiary. Therefore, the accounting department outlined the policies and procedures which would substantiate this position. Even details such as supper-money practices and letterheads for interoffice memos were made to conform to an operating division.

Now that the war is over, the mill has been sold, and *Time's* tax position was established on a basis determined by operating procedures set by the accounting department. That is double-duty accounting.

Personnel Relations

You all know that the film industry is organized by unions down to the last man and woman—and even the falsies occasionally get mixed up in film-union troubles.

From 1938 to 1940, when the wage-hour problems were new, the film unions were chuckling. To add to the confusion resulting from their own curious working rules, here was the federal government adding to the employer's troubles. Well, to our accounting department that was the last straw. We decided to turn all that work to good use. We had to keep so much prescribed data that with but a little more work we put together many new facts and figures. Then, we filled the next union negotiation so full of new statistics that a completely new approach to our problem of working conditions was possible. The union liked it and our operating staff liked it, for at last there was no disagreement on what shifts and hours were worked in what order, by what men, and the problems of how much notice on calling a shift or cancelling it seemed to be settled. The accounting department had made a very tangible contribution to business-policy determination.

CHAIRMAN ECKELBERRY: Thank you, Mr. Wood.

Our next speaker is also with one of the country's large department stores. I am very happy to present Mr. Harry R. Edwards of the Class of 1928. Mr. Edwards is the controller at F. and R. Lazarus and Company. Mr. Edwards.

EXAMPLES ILLUSTRATING THE USE OF ACCOUNTING IN BUSINESS-POLICY DETERMINATION

By HARRY R. EDWARDS, C.P.A.

Controller, F. and R. Lazarus and Company, Columbus

In approaching a subject such as this, one finds the material so plentiful that his difficulty in a fifteen-minute talk is to confine his efforts to the bare outline of only a few of the problems encountered every day in the retail business. I shall try, in this very brief period, to sketch for you several cases from my own experience where accounting does furnish management with the necessary tools for formulating policy.

The importance of accounting reports in guiding management in everyday business policies cannot be overestimated in the retail business. The figures contained in these reports are scrutinized daily, weekly, monthly, and annually. On the basis of these reports, management determines its policies, alters them from time to time, corrects its plans on the basis of changing trends shown therein, and, after the period, checks its performance by them against its predetermined estimates. In all of these activities, the accounting figures play a vital part. They are not static historical legends when management utilizes them; they become living dynamic partners in the business, speaking to those who are listening for their hidden meanings and who can interpret them.

Let me mention a few of the reports which act as daily tools for retail management and the periods covered:

1. Sales—daily, weekly, monthly, and annually
2. Orders placed and cancellations—weekly
3. Purchases—weekly, monthly, and year to date
4. Stocks—weekly
5. Markdowns—weekly
6. Markup percentages—monthly
7. Financial statements consisting of balance sheets, operating statements, and expense statements—monthly, year to date, and annually
8. Personnel information—number of people, number of employee hours and pay-roll cost—weekly
9. Production figures such as dollar sales per employee and selling cost, as well as number of units of work performed in nonselling departments. An example might be: number of accounts-receivable statements posted per hour—monthly.

In addition to these numerous internal reports which are submitted to our management and operating personnel, many of the same figures are submitted to statistical agencies, such as the Controllers Congress of the N.R.D.G.A., the Retail Research Association, Harvard University, the Bureau of Business Research of The Ohio State University, and Federal Reserve Bank Research Departments, where they are tabulated and compared with the figures of other organizations; thus, many valuable business indicators are made available to contributors.

All of these reports, prepared and analyzed by our accounting departments, are the everyday meat-and-potatoes variety of accounting information, but let's not minimize their importance; they are the daily guides to alert managements and they indicate current trends which are really used in our business.

When a business organization enjoys growth beyond the capacity of its physical plant location, it becomes necessary to decide whether additional facilities are to be procured to continue that growth or whether other steps are to be taken. We sometimes find that increases in volume are not the only contributors to a more profitable operation, although volume is a powerful factor in any business venture. It may be more desirable in some cases to analyze additional business potentials and screen out just the additional business which produces the most profit. Everyone of us has witnessed the disastrous results of promiscuous overexpansion.

I remember one case in particular where a small manufacturing operation was carried on in a crowded building. Production lines were cramped, lighting was bad, working conditions were, to say the least, difficult. The demand for the product grew rapidly and because of its low-cost position, the company figuratively "coined money." Management obtained a new factory site, installed a beautiful production layout, provided excellent working conditions for its employees, and then the blow fell. A large competitor came into the field, the company's market had to be shared and the small, new plant suffered a major curtailment of its production. Moral: Be conservative in your expansion plans.

In the retail business the solution of the problem of expansion beyond physical plant capacity may be found in a number of moves. I shall mention three and the type of accounting information which would be submitted to management to assist it in making its decisions in the case of each.

A. Branch Stores

The advantage of branch stores, of course, would be the diversion of the volume growth to remote locations in suburban shopping centers or smaller towns in the hinterland where rental costs are lower than corresponding expansion costs would be at the main store location. An opportunity would also be presented to tap a new source of sales potential. I shall not mention the many merchandising considerations which would go into making a decision for branch stores, but the accounting information necessary for management's consideration is briefly as follows:

1. Cost of branch store building—either purchased or rented
2. Costs of transferring merchandise to that location
3. Maintenance costs
4. Personnel costs and organization
5. Estimate of sales potential.

These are only a few of the items which would have to be forecasted before a decision could be made to establish such a branch location. Needless to say, the preparation of accounting figures would be necessary and most of the facts would have to be compiled from either existing accounting records of the main store or by reference to the figures and experience of other similar businesses.

B. Remote Warehouses

Another method of providing for additional growth is the establishment of remote warehouses in order to more efficiently utilize the space at the main location for the all-important sales activity. Here the considerations would be:

1. Cost of warehouse building either by purchase or rental
2. Cost of insurance and taxes
3. Cost of transportation to warehouse and transfer between warehouse and store
4. Cost of pay roll and operating organization.

Accounting information intelligently prepared would undoubtedly be necessary in order to recommend or reject such a plan.

C. Relocation of Non-merchandising Activities Away from Main Store Location

In order to free the main location for fuller utilization of its space in selling, an analysis must be made of non-merchandising activities with regard to the necessity of their proximity to the selling activities. Certain operations, such as workrooms, service departments, some office departments, may be carried on just as efficiently at remote locations as at the main store. Here it would be necessary to analyze rental costs and operating procedures in the new location as compared with the present location. The contacts of the department with other departments, cost of moving, materials, communication, and the transmission of reports would have to be scrutinized. Accounting records would be called upon to furnish much of this information.

In many instances, in order to successfully carry on one type of business, it becomes necessary to acquire the control of another business in order to insure continuity of supply of merchandise or service. In the manufacturing business we often read of a processor acquiring a mill, or of a steel plant acquiring a mine. In a retail business, it may be a warehouse company or an appliance distributor. When this step is necessary, the organization to be acquired must be examined as to its financial history and operating record, its current financial condition, and its prospects for the future. This determination is an accounting job. The decision to acquire depends largely upon the information obtained from an accounting investigation. The determination of the current financial position undoubtedly would require an audit by a certified public accountant but much of its supplementary data regarding history and future prospects would be developed by the accounting staff of the acquiring organization. The extent and nature of the information to be obtained would be the responsibility of the accounting executive.

At this point, another phase of accounting would be involved. In the acquiring of assets or capital stock of another organization, the impact of taxes (federal and local) would have to be investigated, and this data would have an extremely important influence upon a decision to acquire or reject, or the manner in which the acquisition was performed. In one case in my experience, purchase of assets would have been desirable. Time does not permit the description of an example of this type of transaction; however, the problems encountered are many, and accounting and tax techniques play a major part in the policy making.

One of the most important of the retail accounting executive's tasks is the supervision of credit activities. This consists of three major functions which are described as follows:

1. *Credit granting*. This phase starts with the opening of a customer's account. Information as to the customer's personal qualifications for credit are obtained from the applicant and this information is checked independently with credit bureaus, banks, and other references. This phase also includes the authorization of individual purchases as made and the scrutiny of credit limits which have been established in the opening of the account.

2. *Collections*. This function consists of analyzing the customer's accounts continually to see that payments are in accordance with agreements made at the time the account was opened or later agreed upon.

When payments lag, collectors must notify the customers of their delinquency and follow up the notifications to achieve collection. Occasionally, it is necessary to adopt stringent methods to attain collection of difficult accounts.

3. *Credit promotion.* This is the good-will mission of the credit department. Inactive customers are contacted to determine the reason for their forebearance. New arrivals in the city are contacted to bring them into the credit family. By analyzing the accounts, selected groups of customers' names may be furnished to the selling staff for special merchandise promotions. The credit records are one of the organization's most treasured possessions.

It is common knowledge that by the tightening or relaxation of credit policy, a decided effect can be produced upon sales. The accounting executive must be alert to the possibilities offered in this connection. He should be able to find that intangible line where credit losses balance the profit produced by additional sales, at least within reasonable bounds. Credit policy may then be set to capture this lucrative additional business without endangering the financial condition of the company. Many a credit manager has shut the door on thousands of dollars of profit by an overcautious credit policy. On the other hand, we find those who are entirely too lax in credit granting to the detriment of the profit picture through high credit losses. The accounting executive, through analysis of customers' paying habits and of profit margins, is equipped to render an invaluable service to his management in making recommendations as to credit policy.

In this presentation, I have attempted to hit the high spots in mentioning phases of policy determination which are influenced by accounting. The foregoing speakers have all emphasized some particular point in the influence of accounting. The point that I wish to make is that, just as in an orchestra, each instrument contributes some essential part to the selection, so in business operation, each facet of accounting reflects a particular, essential phase in order to guide management in the achievement of its goal—a profitable venture.

CHAIRMAN ECKELBERRY: Thank you, Mr. Edwards.

You have read about football coaches going from one school to another and taking certain players with them. Our next speaker took his bachelor's degree at the University of North Dakota. Professor Taylor was there. Professor Taylor came down here and Mr. Wilder came with him. It is my pleasure to present Mr. Harrison Wilder, a certified public accountant now with Ernst and Ernst of Detroit.

EXAMPLES ILLUSTRATING THE USE OF ACCOUNTING IN BUSINESS-POLICY DETERMINATION

By HARRISON W. WILDER, C.P.A.
Ernst and Ernst, Detroit, Michigan

The subject of "Use of Accounting in Business-Policy Determination" fortunately lends itself to a broad interpretation and provides substantial latitude in the selection of cases for discussion.

There are probably a number of situations in which the method of accounting influenced the business policies or practices. Illustrative of this type are the cases of companies which use the last-in, first-out method of inventory valuation. In many instances, the rising unit costs of inventory, with the resultant desirability from a tax standpoint of not depleting the inventories, has had a substantial influence on the production and delivery schedules in the later months of the fiscal years of those companies.

The extent to which the last-in, first-out method of inventory is used is disclosed in the May, 1947, letter on economic conditions issued by the National City Bank of New York. This publication stated that "of the one hundred largest American manufacturing corporations, based upon volume of sales last year, thirty-six, representing thirty-eight per cent of the total sales of the group, used 'lifo' in whole or part."

Normally, the accounting, except for budgeting and forecasting, follows the establishment of policies and is the means of disclosing the financial results of the application of these policies. Therefore, a large number of cases in which accounting influenced business policy consist of instances where a special accounting investigation or the installation of improved accounting controls or techniques disclosed information which led to changes in existing policies. The following highlights of several cases in this category are illustrative of this type of influence:

In the first case, the company made die castings and stampings, and also performed some assembly work on the stamping materials. The company was losing a substantial amount of money at the time the accountants were called in. It was found that the estimating procedure was faulty and that there was practically no knowledge of product costs with which to compare the estimates. A standard cost system was installed, each productive operation was time studied, and daily performance reports were developed. Provision was made for the proper departmentalization of costs for purposes of allocating overhead, since casting, stamping, and assembly work have substantially different overhead rates. Temporary overhead rates were developed for use until sufficient data could be gathered to set actual rates. In the light of the new costs developed, it was necessary to re-estimate each job. As a result of ability on the part of the company to ascertain accurate costs, it was able to reset its selling prices in line with such costs, with a resultant average increase of twenty-five per cent. This increase, together with the savings made in labor costs through better control, was adequate to yield a comfortable margin of profit.

Another case involved faulty organization with respect to responsibility and authority, inadequate accounting, and untidy plant housekeeping. The lines of responsibility and authority of the principal operating personnel were so poorly drawn that the sales manager had no contact with the factory, the comptroller had no representatives in the plant, and the factory manager was not interested in the development of costs and was furnished with none. The comptroller could not get cost data from the shop in the manner necessary to operate a satisfactory cost system, and the sales manager, who set prices, was unable to obtain accurate data as to costs. It is almost axiomatic that the company was losing money under such an operating arrangement. When the accountants were called in, it was obvious that a major overhaul was necessary. It was found that a general housecleaning was needed in order to tidy up the plant to meet ordinary standards. A substantial variation in costs was being experienced which was finally traced to faulty weighing of materials. This was occasioned by failure to regularly clean the weighing mechanism which gradually accumulated wax used in the processing.

It was necessary to change the organization chart to give the comptroller control over the policies and practices in the shop so far as they pertained to preparation of the basic-accounting data. This included particularly the timekeeping and material requisitioning procedures. A number of erroneous practices in cost allocation were noted, such as charging trainee labor in full to the job on which a new employee was working. This practice resulted in some jobs showing substantially disproportionate costs which were left completely unexplained to the sales manager who had made the original sales estimates. The accounting allocations of costs were corrected to syphon off those items which should have been treated as overhead costs rather than as direct charges to jobs. The proper allocation of costs permitted the sales department to estimate selling prices in a sound manner and provided accurate costs against which the estimates could be compared. Also, the factory manager was supplied with accurate cost data which was usable as a tool in controlling operations. The realignment and clear definition of the duties and responsibilities quickly changed the executive relationship to one of teamwork and cooperation, which is necessary to profitable operations.

A third case is of interest because of its unusual features in the payment of labor. The company manufactured a rather simple product requiring stamping, assembly, and filling operations. A study of the product costs disclosed that the only means of reducing costs to the point necessary to meet competitive prices was by improving the labor efficiency. The study disclosed that an increase in efficiency of approximately twenty-five per cent was necessary, and schedules were set on that basis. The employees were notified that they could leave the plant upon completion of their required quantities and would be paid for a full eight hours of work. Shortly after the inauguration of this incentive plan, the scheduled production was being completed in about six hours. The method has proved to be of considerable advantage to the company, not only by reason of the decreased direct labor and indirect costs, but also through improved labor relations and a practically guaranteed production schedule. Through stabilized production, the company was able to meet its shipping schedules throughout the war, as well as to plan its material and financial requirements with substantial certainty.

The next case concerns a company which had several manufacturing plants and also owned and operated most of its own retail sales outlets. Its public accountants were requested to make a survey of the procedures and policies of estimating and cost accounting, and also to consider the methods of measurement of effectiveness of the key personnel in its manufacturing plants and sales branches. The survey disclosed that in many estimates on which the selling prices were based, the material costs were determined by increasing the standard costs by the average material variance recently experienced. The inaccuracies which could develop in estimates prepared in that manner were apparent, particularly where there are substantial differences in the materials required for the various end products. The procedure was changed to require the use of a bill of material priced at current or anticipated costs. The review of the cost-accounting system showed it to be generally satisfactory; however, the method of allocating costs to the units of the business and the resultant reports did not provide management with the information of which the system was capable. It was the management view that the manufacturing and retailing functions were so integrated that the entire operation should be considered as a whole, with the result that the operating statements were prepared in such manner as not to disclose the efficiency of the individual plants and branches.

After a thorough study of the situation, it was recommended that the concept that the operations must be considered as one unit be abandoned and that each unit, both branches and plants, be set up in such a manner that each could be measured by the profit it produced. This recommendation was accepted by the management, and the necessary steps were taken to put it into effect. The first step was to change the basis of billing from the plants to the branches from a so-called "actual" cost to the net price charged to outside dealers. This change fixed the unit cost of finished products and thereby placed the variations in profit entirely under the control of the branch managers. This opened the way to a management bonus based upon profits. Further, the revised method showed the net results of operating the factory branches as compared with handling all distribution through outside channels. In the plant operating statements, the cost variances which formerly were allocated to the branches were set out as separate items to focus attention on the variations from planned costs. It was found that each plant manager could control the standards by which his performance was measured and that changes in standards were made whenever the standard and actual costs differed materially. This was corrected to provide for only annual changes, except for major factors such as general wage increase. By means of billing the sales branches at the outside dealers' net price, the planned income of the manufacturing plants was established, and the profits of each plant were determinable.

This change in presentation of operating data shifted the emphasis from efficiency measured by standards to measurement by actual profit. It had the effect of encouraging the plant managers to search for means of cost reduction and savings of expenses, rather than for reasons to increase the standards. The results obtained in the short time during which the new plan has been in operation indicate that the change in policy will be highly beneficial.

In another case, the company became alarmed when the ratio of its indirect factory labor to productive labor became double that experienced in its production prior to the war. Its public accountants were given the assignment of making a survey of the plant operations with the primary objective of establishing an incentive system for indirect labor. At the inception of the survey, it was noted that eighty per cent of the indirect labor was represented by the material handling, inspection, and maintenance classifications. An investigation of the cause of the high material handling costs revealed that the function was under the supervision of the planning department and, further, that in laying out the production lines, the engineering department had failed to give proper consideration to the matter of storage of components at the points at which they entered the assemblies; also, the equipment used in trucking the materials was found to be obsolete in design. To correct the situation as to material handling, the responsibility for the handling methods was placed with the process engineering department, and the layout of the lines was redesigned for greater and more efficient production.

Next was the problem of inspection labor. Investigation disclosed an absence of any scheduling of inspection manpower requirements based upon production schedules. In fact, the chief inspector did not definitely know the stations of several of his inspectors. This source of waste was corrected through the installation of methods of predetermining the manpower requirements based upon the scheduled production. The maintenance classification was found to include substantial costs for rearrangement of facilities. Although work orders were in use to authorize the work and to state the specifications, costs were not accumulated by orders but were charged directly to the maintenance accounts of the departments for which the work was performed. On questioning the foremen of the maintenance crews, it was found that none expected to reduce his crew upon completion of the non-recurring work, but contended that all of the men would be required for routine maintenance. In order to ascertain the cost of the non-recurring work and to determine the normal requirements for routine maintenance, a separate series of work orders was placed in use for all non-recurring jobs. These orders showed estimated costs and standard time to permit comparison with the actual costs accumulated. No change was required as to routing maintenance, which was handled without accumulation by jobs. This procedure soon disclosed the efficiency of the workmen and the amount of maintenance labor required for routine work at a time when all the crews were busy. The latter information served as a guide for the manpower requirements when only routine maintenance was required. Upon consideration of the foregoing disclosures, it was concluded that the immediate solution to the problem of high indirect labor costs lay not in the installation of an incentive plan for such labor, but rather in the use of proper controls and adequate supervision.

The solutions developed to the problems which arose in the cases mentioned were tailored to fit the peculiarities of the individual situations. Certainly it is not contended that the methods recommended in these cases are the preferred methods for use in all similar types of cases. Practically all engagements involving the revision of methods necessitate the adaptation of such methods to the desires of the management and the special circumstances present in the individual cases. However, the cases do show that the information developed from accounting investigations can have a substantial influence on business-policy determinations.

CHAIRMAN ECKELBERRY: Thank you, Mr. Wilder.

Our next and last speaker is a member of the Class of 1928 and is now assistant controller of the Dayton Rubber Company, a certified public accountant, and a member of the American Institute of Accountants and the Institute of Internal Auditors. I am pleased to present Mr. Myron S. Kem.

EXAMPLES ILLUSTRATING THE USE OF ACCOUNTING IN BUSINESS-POLICY DETERMINATION

By Myron S. Kem, C.P.A.

Assistant Secretary and Chief Accountant,
The Dayton Rubber Manufacturing Company, Dayton

The importance of the accounting department in the determination of business policy has been ably impressed upon all of us during this Ninth Annual Institute on Accounting. We all agree that this has been effectively presented to us. Surely, we who are here see our responsibility. We must put our efforts and resources to the most effective use of the wealth of information which we as accountants have available. When management is properly informed about all the activities of the business, it is only natural to assume that management will make decisions based upon the facts presented in the accounting reports.

The accounting department must furnish management information which will enable them to not only control, but plan future policies, as well as more readily control current operations. The soundness of any program is judged by its financial aspects. I will endeavor, in this paper, to outline some examples illustrating the use of accounting in business-policy determination.

Budgets

A wealth of information is available on budgets. The most important feature of budget installation is the adaptation of the proper type of budget control to suit the needs of the peculiarities of the individual business. However, briefly, I would like to emphasize three basic elements which, among others, are essential to sound budgeting practice.

1. A projected profit-and-loss statement must be based upon soundly predetermined or standard costs. It should be pointed out that the predetermined or standard cost often has failed to bring to management a maximum of benefit because historical averages have been substituted for engineered specifications. Such standards naturally contain all of the mistakes of the past and do not include current developments and future engineered changes.

2. A variable operating budget projecting operations at different lev-

els of production and sales volume is recommended so as to inform management of the profit or loss to be obtained at various volume levels. The crossover chart is generally used for effective presentation to management. It is my opinion that the intelligent determination of the break-even point will assume more importance in business operations.

3. A balance sheet must be projected in order to determine the estimated capital required to finance the operations as proposed in the profit-and-loss budget. This will enable management to determine in advance the need for additional financing and to make the necessary arrangements for it in advance instead of waiting until the need for financing is at hand.

Reports to Management

After the predetermination of future operations on as sound a method as possible, accounting can undoubtedly be of much greater assistance to management by reviewing the character and scope, as well as the readability of its periodic or special reports.

I have selected two subjects which may stimulate creative thinking in reporting on your own particular operation.

Inventory Analysis

Production capacities have multiplied and it is reasonable to assume that sooner or later there will be a surplus of goods. When this occurs, the ability of management will again be tested in a highly competitive market, inasmuch as the consumer will not pay a price which includes the cost of production inefficiencies or excesses in the cost of distribution, which have occurred as a result of our lessened efforts at cost control during the war years. This indicates the need for a much closer study of the accounting records relating to the inventory—an important item in the working capital of most companies. Because of the scarcity of raw materials, it has been necessary in many cases to make commitments far in advance. These commitments are based upon production and sales estimates, but in the event of a sharp break in the market price for the merchandise, a commitment position could very well use up all the working capital of a company. The following inventory information should be available at least once a month or more frequently, depending upon the commitment exposure of the company. (See table at top of page 116.)

Your attention is called to the commitment position compared to the inventory on hand, and its possible effect upon the working capital which is not disclosed in the normal financial statement.

This same type of information should be available for "finished goods inventory," except the number of months' supply on hand should be based

Description	On Hand End of Month	In Transit End of Month	Commitments Outstanding End of Month	Total Inventory and Commitments	Consumption this Month	No. Months' Supply Based on this Month's Consumption	No. Months' Supply Based on Production Schedule
Inventory:							
Item A.	$ 8,000	$2,000	$ 30,000	$ 40,000	$10,000	4	3
B.	19,000	1,000	60,000	80,000	20,000	4	3
C.	12,000	3,000	45,000	60,000	15,000	4	3
D.	9,000	1,000	30,000	40,000	10,000	4	3
Total.	$48,000	$7,000	$165,000	$220,000	$55,000	4	3

upon latest sales estimates or the sales budget, assuming that the sales budget is flexible. The following finished goods inventory report should be made available to your management at least once a month:

Class of Product	Production Current Month	Shipments Current Month	Inventory on Hand	Number Months' Supply	No. Months' Supply Based on Budget Requirements
A	$ 5,000	$ 4,000	$ 4,000	1	1
B	25,000	30,000	45,000	1½	1¼
C	50,000	35,000	17,500	1½	1¼
D	20,000	10,000	40,000	4	2½

Analysis of Sales

Painstaking and intelligent effort should be given to the preparation of sales analyses by the accounting department. The following studies of sales may contribute helpful information to the management of many companies:

A. *An analysis of sales by general product classifications.* This analysis should be grouped by "class of customer" or "channel of distribution," and should portray the following information:

	Actual	% to Sales	Budget	% to Sales
General classification of product.				
Number of units sold.........				
Net sales				
Standard cost of sales..........				
Factory variances				
Actual cost of sales............				
Actual gross profit............				

This analysis reveals the standard cost and the per cent to sales of such cost that was actually attained as compared with the predetermined expectancy for each general classification of product. The only deviation possible between these percentages should be the deviation in ratios among the sizes or types within product classifications, or the failure to maintain established selling prices.

Factory variance applied to gross profit will call for an analysis of such factory variations. Showing factory variance as a separate item is usually helpful in isolating causes for disparities in actual and budgeted gross profit between production costs and sales operations.

B. *An analysis of sales by territories.* This analysis should show:

	Actual	% to Sales	Budget	% to Sales
Net sales				
Percentage to budget..........				
Standard cost of sales..........				
Standard gross profit..........				
Salesman's direct costs.........				
Other (branch office, etc.) direct cost				
Total direct sales cost........				

This analysis is prepared in order to obtain a comparison of performance in each territory or other grouping best suited to the company, measured against the budget, which is the anticipated business from each territory. The performance of your salesmen should not be measured in dollars alone. Usually, the soundest measurement is against the budgeted volume within the territory. This budgeted volume should be established upon some sound predetermination, such as a market analysis of the potential within the territory, potential new accounts, or myriads of other factors which may be developed by sales or merchandising studies.

If the success of the salesman is measured by his dollar volume without such analysis as herein described, a good salesman can be classified as a poor salesman, and, vice versa, a poor salesman, because of his large dollar volume within a good territory, can be classified as a good salesman. This analysis will measure the results obtained in the territory as related to a properly determined potential existing in the territory.

The standard gross profit in many companies may be inadvisable to disseminate throughout the sales organization; however, it is well to consider whether this information may not be of value to the sales management in knowing the contribution a territory makes toward the support of operating expenses.

I have not attempted to interpret the examples which were given in this paper. The interpretation is not an academic problem, but far transcends the accounting report. In my opinion, the interpretation of the information presented in these reports depends upon the particular problems of an individual company and is the function of management.

In this paper, I have not given any examples, except for a brief refference to the budget, relating to the control of fixed assets, manufacturing, or administrative expense. If management is to maintain the type of control which will be required to measure the effects upon profit of changing costs, changing prices, or changing volume, analytical studies similar to those presented herein will have to be presented to the management by the accounting department for all operations of the company.

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